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# FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1985

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 18, 1985

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# FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1985

THURSDAY, JULY 18, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Riegle, Dodd, and Sasser.

## OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This morning we are convening for the purpose of hearing the testimony of the Honorable Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System, regarding the second monetary policy report for 1985.

I can't help but notice when this Committee's hearing on monetary policy comes second, after the House's, suddenly the interest level seems to drop off. I don't think the audience expects you to say something different today from what you did yesterday, Mr. Chairman.

Mr. VOLCKER. It's all in the interpretations of what I say. I will say the same thing.

The CHAIRMAN. Well, we'll see if they interpret you differently today than they did yesterday or when you released your testimony the day before.

But we are always happy to welcome you before the committee. I'd like to turn to Senator Proxmire for any statement he wishes to make before you begin.

## OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Mr. Chairman, your statement may be similar but the questions may be different, and if the questions are different maybe your responses will be different. So we will try to do our best. I do have a statement.

The Fed has just come off one of the most successful economic achievements in recent history, breaking the back of the superinflation that engulfed this country in the late 1970's. The Fed has done this with no help from the Congress. In fact, they have done it in the face of the most irresponsible congressional fiscal policy in the Nation's history.

That's the good news as far as the Fed is concerned. It's impressive. There's also bad news and that's impressive too. This year the Fed has shown an appalling inability to come within a mile of its monetary targets. It grossly missed forecasting any hint of the astonishing slowdown of the economy in the first quarter of 1985 and now the Fed has responded with a changed policy. So far in 1985 and especially in the last 2 months, the Fed has permitted one of the most explosive growths in the money supply in recent history. The growth has not only breached the Fed's range for M1, it has made that range look ridiculous. The chairman has opined that maybe the Hutton fiasco has so jarred corporate managers that they are leaving larger balances in their corporate accounts. Well, maybe.

But the 10.6 percent increase in M1 in the first half of 1985 is about 50 percent above the top of the Fed's target range. And, of course, in June the money supply really exploded out of control with annual rate increase of 19.6 percent. Chairman Volcker and the Fed hammered money supply increases down beginning in late 1979 and continuing right through much of the deep recession of 1981 and 1982. They brought inflation to its knees. Of course, it is true that the prospect of inflation seems to have diminished to a shrunken shadow of itself at this time. We are told this morning that real economic growth in the second quarter of 1985 was 1.7 percent. Combine that with the 0.3 percent in the first quarter and the real growth for the first half of this year and it is a pathetic 1 percent. Unemployment is still high, in fact at the same recessionary rate of 7.3 percent it has been stalled at for 5 months. There is no inflationary pressure from a wage push in sight. We have a glut and a growing glut of oil, in fact a surplus so immense that even that fabulously rich industry is in trouble. Our food glut is so huge that our farmers are suffering a deep depression and food prices are almost sure to rise little if at all. Industry operates well below capacity.

So where is the inflation? Where is the threat of inflation? The massive and continuing Federal deficits pose an inflationary threat and that seems to be some time in the distant future after these colossal surpluses begin to disappear. Does that mean inflation is licked? Can we forget it? Is the 10.6-percent increase in the money supply for the first 6 months of 1985 and the nearly 10 percent increase last month along, is this simply a temporary quicksilver flash that will not and cannot pose any real inflationary threat?

The answer may be yes, we can forget inflation; it's licked. Labor cannot get inflationary wages when they suffer more than 7 percent unemployment. Oil prices and that means all energy prices cannot go up with the worldwide glut. Food prices will stay down. So where could inflation come from?

The answer is that inflation could come from four sources. First, from the Federal deficit. Second, it could also come from the very likely decline of the dollar. That decline will ease the competitive pressure of imports that now hold down domestic prices and directly raise the prices of the hundreds of billions of dollars of imports this country buys from abroad. The third source of inflationary pressure could come from a proposed 25-percent tariff on the imports of four of our principal trading partners, including Japan.

That bill has very strong support in the Senate. It's going to have stronger support as time goes on, particularly if the present trade situation continues. The fourth and final source of inflation will emerge from a more comprehensive and certain long-time force. Our experience and commonsense tells us that inflation is a monetary phenomenon. No matter how the supply of goods and services increase, if the money supply increases faster, the value of that money will surely fall. What does that mean? It means that prices will rise. If the economy is growing at a 1-percent rate in real terms, which it has been for the first 6 months, and the money supply is growing at a 10.6 percent rate, let alone a 20-percent rate, the difference will show up in higher prices. Unfortunately, that sure and powerful hand of Mr. Volcker won't be around when the higher prices that follow from this explosion of the money supply hits the country. Why not? Because in the past we have found that as the money supply increases a lag of about 2 years or 24 months follows before they are reflected in higher prices. That means that sometime in the summer of 1988, a few months before the 1988 Presidential election, prices will begin to climb. Chairman Paul Volcker will probably not be in charge of the Fed in 1988 to bring things under control. The fiscal policy of our Federal Government is likely to continue to be highly inflationary. In fact, our 1988 debt that will be far above $2 trillion and on its way to $3 trillion will offer a tempting reason to let inflation have sway so the Government can pay off its towering obligations on the cheap.

The last couple of months have been troublesome months for those who fear the consequences of inflation and mammoth Federal deficits. The President and congressional leaders seem to have signed off on a no new tax and the higher spending figure of the House or the Senate Budget Committee. The administration's strongest advocate of fiscal restraint, David Stockman, has announced his departure. And now we are told that the Fed figures that inflation is licked so it is declaring victory and throwing in the sponge following a month when the money supply grew at a nearly 20-percent annual rate. Argentina—here we come.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. I have no formal statement, but, Chairman Volcker, I'm going to have to leave a little bit later. I have a conflict with two other committees, but I do want to say that I do applaud your present policies and I hope you will continue them.

The CHAIRMAN. Do any of my colleagues wish to make an opening statement before we turn to the Chairman?

Senator CRANSTON. I don't want to impose on his time. I do welcome you, as always.

Senator D'AMATO. Mr. Chairman, I'd like to just submit for the record my statement in its entirety and I, too, join my colleague, Senator Hecht, in indicating that I believe that the Fed's policy—and I don't think Chairman Volcker will say loosening up—but the policy that you have been following in providing some stimulation, particularly in the construction area and the money growth area, has been a beneficial one and has not been inflationary in nature, and I think it still pursues a steady course, one which I certainly am supportive of.

## STATEMENT OF SENATOR D'AMATO

Good morning Mr. Chairman. Before we begin, I would like to welcome Paul Volcker here today. As always, Mr. Volcker, you are diligent in responding to this committee's requests. Today's hearing will examine the Federal Reserve report in respect to the conduct of monetary policy for 1985.

The original targets for basic money supply, M1, projected a growth of 4-7 percent in 1985. This was approved in February. I am now informed that the Federal Reserve has widened its M1 target from the original projection to 3-8 percent in an attempt to ease credit and to spur an economy which has become sluggish in recent months. I am concerned that the Federal Reserve may be becoming overly cautious with respect to the economy and that your recent monetary policy may spur higher inflation.

In recent months the money supply has been soaring far above the Fed's target for this year, growing at an 11.6-percent annual rate through June. As of June the money supply was $15 billion above the upper end of your original target range. Even with the new targets issued 2 days ago, it would be $4.7 billion over your upper end projection.

It is my hope that money growth will slow on its own accord in the near future. The question of the Fed's role in slowing the growth of the money supply, however, may now only be month's away. If the result is the tightening of credit, the outcome may be less than desirable.

The economy in its present state, as sluggish as it may appear, remains stable. Inflation has continued to remain in the 4-percent range, unemployment has been steady at 7.3 percent for the past 4 months, and the economy continues to grow, although at a slower pace than a year ago.

I realize more can be done here on the Hill to control the Federal budget deficit in attempt to spur the economy, but the role of the Federal Reserve Board can never be taken lightly. No other section of the Government has the power over the economy you hold. It is for this reason this hearing is being held. It is my sincere hope that the economy will continue to expand under the policies of the Federal Reserve.

Thank you, Mr. Chairman.

The CHAIRMAN. Chairman Volcker.

## STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, as you noted, there's been a certain amount of publicity about our decisions and my testimony yesterday and the press briefing the day before and I won't read my statement this morning. I may just take 2 or 3 minutes to make a couple of introductory comments.

### PROGRESS IN THE ECONOMY

The burden of my statement is that there has clearly been a good deal of progress in the economy over the past 2 or 3 years. We have had altogether, despite the slowdown in the past year, a

strong business expansion, a business expansion that has helped lift growth in the rest of the world as well as in the United States, and so far we have combined that with a more contained inflationary picture. But it is also apparent that there are very large imbalances, a disequilibrium in the economy, that can't be resolved by monetary policy, certainly not by monetary policy alone.

You are fighting that battle now in the Congress about the deficit, where we urgently need some restraint. The protectionist threat that Senator Proxmire referred to is certainly there, and I think it is terribly important that that be contained. Certainly I would emphasize that it is a serious misreading of our intentions if you think that in any way we have grown soft on inflation.

Senator Proxmire has cited some of the factors that have been moving in the other direction on the inflationary front, but certainly the inflation problem has not been licked. There is a good deal of momentum of past inflation remaining in the economy. Expectations are sensitive, and we have to remain very cautious on that score.

PRINCIPAL RISKS

He cited the principal risks there, the risk of the deficit, the risk of the dollar. Those risks would be gravely compounded by excessive growth in money and credit. We may differ on an explanation of what's going on now, but we don't differ at all in terms of the importance of maintaining control in that area over a period of time.

I might say that the GNP data we have this morning, which is a downward revision from the so-called flash report, deserves a little analysis. A downward revision is not at all surprising. What's interesting to me is that this new figure shows an even stronger increase in domestic final purchases than we thought we had before and than I cited in my statement. I cited that it had been running more than 4 percent the first half of the year. If you look at these latest figures, it's running nearly 5 percent and over 6 percent in the second quarter. The downward revision can be entirely traced to higher imports and lower exports than were initially anticipated by the Department of Commerce, and particularly to a sharp decline in the rate of inventory investment. I don't think that latter factor necessarily at all varies for the future. We have maintained final demands here very well. We have an industrial production figure that was announced this morning that shows a very small increase in June which in itself isn't significant, but there are longer term revisions of that figure which show more growth this year than we previously had reported.

We are very conscious of the fact that we face some dilemmas and imbalances that can't be corrected by monetary policy alone, but the inflation question has to retain priority in our thinking.

With that much general introduction, Mr. Chairman, I would be glad to entertain whatever questions you have.

[The complete prepared statement follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I welcome the opportunity to review with you monetary policy in the context of recent and prospective economic and financial developments. The economic setting and the decisions of the Federal Open Market Committee with respect to the target ranges for the monetary and credit aggregates are set out in the semi-annual "Humphrey-Hawkins" Report. As usual, I would like to amplify and develop some aspects of those decisions in my testimony.

The Economic and Financial Environment

The pattern of slower, and more lopsided, growth in domestic output that developed during the latter part of 1984 became even more pronounced during the first half of 1985. Manufacturing activity overall has been essentially flat following exceptionally large gains earlier in the expansion period. The farming and mining sectors have remained under strong economic and financial pressure. But consumption -- supported directly and indirectly by large increases in personal and federal debt -- has continued

to rise fairly strongly. Construction activity has also expanded, responding in part to lower interest rates. Despite recent losses of manufacturing jobs, employment growth in services and trade has been strong enough to keep the overall unemployment rate essentially unchanged at about 7-1/4 percent.

The contrast between marked sluggishness in the goods-producing sector of the economy and rising domestic consumption and demand is reflected in continuing strong growth in merchandise imports. Those imports in real terms are up by about 60 percent in three years; in manufactured goods alone the increase has been even more rapid. Overall, imports have now reached a level equivalent to 21 percent of the value of domestic production of goods. In contrast, exports have stagnated, and now account for only about 14 percent of goods output.

I can put the same point another way. Domestic final sales -- to consumers, to businesses, and to governments -- appear to have been expanding at a relatively brisk rate of

more than 4 percent so far this year. Domestic output of goods and services has not nearly kept pace, rising at a rate of around 1-1/2 percent or perhaps less. That is partly because inventory accumulation has slowed. But it is mostly because more of the domestic demand is being satisfied by growing imports.

That was true earlier in the expansion period as well. But we have felt it more as growth in demand has slowed to a more sustainable rate. Another potentially disquieting development has been the apparent failure of productivity to maintain the strong gains achieved earlier in the expansion period. The implication is that the underlying trend may not have increased as much as hoped from the poor record of the 1970s.

Against these cross-currents in the economy this year, the Federal Reserve, in conducting its open market operations, has not appreciably changed the degree of pressure on bank reserve positions, which had already been substantially eased by the end of 1984. In May, the discount rate was reduced from 8 to

7-1/2 percent. That action was consistent with the general tendency of market interest rates to decline further over the period, extending the rather sharp reductions during the Autumn and early last winter. Both the discount and short-term market interest rates in May and June reached the lowest levels since 1978.

The relatively "accommodative" approach in the provision of reserves has been designed to provide support for the sustained growth of economic activity against a background of relatively well contained inflationary and cost pressures. Indeed, sensitive agricultural and industrial prices -- including prices of crude petroleum -- have been declining appreciably, and prices at the wholesale level have been almost flat. It is somewhat reassuring that the trend in wage and salary increases has, overall, remained at the sharply reduced pace established at the start of the recovery period, although the slowdown in productivity has been reflected in higher unit labor costs and some pressures on profit margins. Clearly, even if reduced, some momentum of

inflation has persisted in the economy as a whole, and expectations remain sensitive. But so far this year, price increases have been concentrated largely in the service sectors.

Meanwhile, the broader measures of monetary growth -- M2 and M3 -- have remained generally within the target ranges established early in the year. However, currency and checkable deposits, measured by M1, have increased much more rapidly than envisaged. (See the attached charts.)

Until May, growth in that aggregate remained in an area reasonably close to the upper band of the target range. Given that the more rapid growth during that period followed some months of subdued expansion, the outcome through April was reasonably in line with FOMC intentions and expectations. More recently, in May and June, a new surge in M1 carried that aggregate much further above the targeted range.

At the same time, total non-financial debt has continued to expand substantially more rapidly than the GNP, propelled particularly by the federal deficit and consumer credit. As

much as 1 percent of that debt expansion can be traced to a continuing -- and, from a structural point of view, disquieting -- substitution of debt for equity as a result of mergers and other financial reorganization. More generally, these developments also point up the apparent dependency of economic growth, under circumstances existing this year, on a relatively high level of debt and money creation.

Unduly prolonged, those developments would not provide a satisfactory financial underpinning for sustaining growth in a context of greater price and financial stability. For the time being, however, taking account of current and likely economic developments, the downward pressures on commodity prices, and the high level of the dollar that has prevailed in the foreign exchange markets, the growth in M1 and debt has not in itself justified a more restrictive approach toward the provision of reserves to the banking system.

After increasing sharply from already high levels in the early weeks of the year, the dollar more recently has fallen back against the currencies of other leading industrial countries, dropping abruptly over the past week or so to about the average levels of last summer. At these exchange rates -- still about 60 percent above the relatively depressed levels of 1979 and 1980 -- prospects for stemming the deterioration in our trade accounts, much less achieving a turnabout, remain uncertain. Much depends upon the rate of growth in other countries that provide the principal markets for our exports and are the source of our imports. In any event, the potential effects of interest rates and decisions with respect to monetary policy on exchange rates and the external sector of the economy have necessarily been a significant ingredient in FOMC deliberations.

The Outlook for the Economy

Members of the FOMC generally have projected a pickup in economic activity over the second half of 1985 and sustained

growth through 1986. In those circumstances, while employment gains should remain substantial, unemployment would be expected to drop only a little if at all. The overall rate of price increase would be expected to remain close to the recent pattern, assuming dollar exchange rates do not vary widely from recent levels. (See Table I attached for the numerical projections.)

Obviously, neither the anticipated "stickiness" of the unemployment rate nor the projected inflation rate is entirely satisfactory, and a substantial range of uncertainty must be associated with any economic projections at this time. As I emphasized earlier, there are sharp differences in the performance of different sectors of the economy. Demand for and employment in services, where most upward price pressures have been concentrated, continue to expand rather strongly. Most sectors more immediately sensitive to interest rates and monetary conditions -- including construction and automobile sales -- have also been performing relatively well. Other sectors exposed to strong international

competition are sluggish, and agriculture remains under strong financial pressure.

The Broad Policy Challenge

The cross-currents, dislocations, and uncertainties in the present situation point up one uncomfortable but inescapable fact. We are dealing with a situation marked by gross imbalances that can neither be sustained indefinitely nor dealt with successfully by monetary policy alone, however conducted.

-- We are borrowing, as a nation, far more than we are willing to save internally.

-- We are buying abroad much more than we are able to sell.

-- We reconcile borrowing more than we save and buying more than we sell by piling up debts abroad in amounts unparalleled in our history.

-- Our key trading partners, directly or indirectly, have been relying on our markets to support their

growth, and even so most of them remain mired in historically high levels of unemployment.

-- Meanwhile, our high levels of consumption and employment are not being matched by the expansion in the industrial base we will need as we restore external balance and service our growing external debt.

-- And, after 2-1/2 years of economic expansion, too many borrowers at home and abroad remain under strain or over-extended.

At their core, these major imbalances and disequilibria may lie outside the reach of monetary policy -- or in some instances, U.S. policy generally. But they necessarily condition the environment in which the Federal Reserve acts, along with all the current evidence about monetary growth, economic conditions, and prices.

In all our decisions, whether with respect to monetary or regulatory policies, we would like to work in a direction consistent with reducing the imbalances, or at the least to

avoid aggravating them. That sounds obvious and straightforward. The difficulty is that, as things now stand, some policy actions that might seem, on their face, to contribute toward easing one problem could aggravate others. Nor can we afford to apply a mere poultice at one point of strain in the hope of temporary relief at the expense of undermining basic objectives.

Our monetary policy actions need to be conducted with a clear vision of the continuing longer-term goals -- a financial environment in which we as a nation can enhance prospects for sustained growth in a framework of greater stability. To succeed fully in that effort, monetary policy will need to be complemented by action elsewhere.

The 1985 and 1986 Target Ranges

As I indicated earlier, the recent surge in M1 in May and June has carried that monetary aggregate well above the target range set in February. M2 and M3, while also rising rather sharply in June, have remained generally within, or

close to, their targeted ranges. Against the background of a high dollar, the sluggishness of manufacturing output, and relatively well contained price pressures, quick and strong action to curtail the recent burst in M1 growth has not been appropriate. The potential implications of the relatively strong growth in M1 since late last year nonetheless had to be considered carefully in developing our target ranges and policy approach.

You may recall that somewhat similar high growth rates in M1 developed during the second half of 1982 and during the first half of 1983. At that time, important regulatory changes involving new accounts and affecting the payment of interest on checking accounts had taken place. Pervasive uncertainty during the latter stages of the recession appeared to affect desires to hold cash. Both circumstances made interpretation of the monetary data particularly difficult, and M1 was deemphasized. Those circumstances are not present today, at least not in the same degree.

However, one common factor, and an important factor, was at work during both periods. The rapid growth in M1 in 1982 and 1983 and this year followed sizable interest rate declines, with a lagged response evident for some months. Analysis strongly suggests that, as market interest rates decline, individuals and businesses are inclined to build up cash balances because they sacrifice less interest income in doing so. The possibility today of earning interest on checking accounts -- and the fact that these interest rates change more sluggishly than market or market-oriented rates -- probably increases that tendency.

Moreover, as I have suggested in earlier testimony, the payment of interest on checking accounts may over time encourage more holdings of M1 relative to other assets, or relative to economic activity, than was the case earlier. Partly for that reason, the upward trend in M1 "velocity" -- the ratio of GNP to M1 -- characteristic of the earlier postwar period may be changing.

That trend was, of course, established during a period when inflation and interest rates were trending upward. In contrast, over the past three and one-half years, velocity has moved irregularly lower, with the declines concentrated in periods of declining interest rates.

The earlier 1982-83 period of rapid growth in M1 was correctly judged not to presage a resurgence of inflationary pressures, contrary to some expectations. I would emphasize in that connection, however, that M1 growth was moderated substantially after mid-1983, and velocity rose during the period of strong economic expansion, as anticipated.

We simply do not have enough experience with the new institutional framework surrounding M1 (which will be further changed next year under existing law) to specify with any precision what new trend in velocity may be emerging or the precise nature of the relationship between fluctuations in interest rates and the money supply. Moreover, while the surge in M1, and the related drop in velocity, can be traced

at least in substantial part to the interest rate declines of the past year, the permanence of the change in velocity will be dependent on inflationary expectations and interest rates remaining subdued. For those reasons, the Committee has continued to take the view that, in the implementation of policy, developments with respect to M1 be judged against the background of the other aggregates and evidence about the behavior of the economy, prices, and financial markets, domestic and international.

None of that analysis contradicts the basic thrust of a proposition that we have emphasized many times -- that excessive growth of money, sustained over time, will foster inflation. Certainly the burst in May and June cannot be explained by trend or interest rate factors. But, it is also true that monthly data are notoriously volatile, and sharp increases unrelated to more fundamental factors are typically moderated or partly reversed in following months.

In all these circumstances, the FOMC, in its meeting last week decided to "rebase" the M1 target at the second quarter average and to widen the range for the rest of the year to 3 to 8 percent at an annual rate. That decision implies some adjustment in the base of the M1 target range is appropriate to take account both of some change in trend velocity and a return of interest rates closer to levels historically normal.

We are, of course, conscious that, because of strong June growth, M1 currently is high relative to the rebased range, and the Committee contemplates that M1 will return within its range only gradually as the year progresses. Consistent with the conviction that a marked slowing in the rate of M1 growth is appropriate over time, the Committee tentatively set the target range at 4-7 percent for next year -- a decision that will be reassessed on the basis of the further evidence available at that time. Meanwhile, the lower part of the range set for the remainder of this year reflects the

willingness of the FOMC, in appropriate surrounding circumstances, to tolerate substantially slower M1 growth for a time should the recent bulge in effect "wash out."

No changes were made in the target ranges for M2 and M3 and the associated monitoring range for debt this year. As was the case at the beginning of 1985, the Committee would find growth in the upper part of these ranges acceptable. The changes tentatively agreed for 1986 are small, limited to a 1/2 percent reduction in the upper limit for M3 and a 1 percent reduction in the monitoring range for debt.

These target ranges are felt to be fully consistent with sustained growth in the economy so long as inflationary pressures are contained. I should note again, however, that members of the FOMC are concerned about the persistent debt creation well in excess of the growth of the economy and historical experience, and therefore look toward some moderation in that growth next year, as reflected in the monitoring range set out. (The new ranges are set out in Table II attached.)

The uncertainties surrounding M1, and to a lesser extent the other aggregates, in themselves imply the need for a considerable degree of judgment rather than precise rules in the current conduct of monetary policy -- a need that, in my thinking, is reinforced by the strong cross-currents and imbalances in the economy and financial markets. That may not be an ideal situation for either the central bank or those exercising oversight -- certainly the forces that give rise to it are not happy. But it is the world in which, for the time being, we find ourselves.

Complementary Policies

The massive trade deficit that has rapidly developed over the period of economic expansion is the most obvious and concrete reflection of underlying economic imbalances. The trade deficit, in an immediate sense, has been primarily related both to the strength of the dollar in the exchange markets and to relatively slow growth elsewhere in the world. In effect, much of the world has been dependent, directly or indirectly, on expanding

demand in the United States to support its own growth. Put another way, growth in domestic demand in Japan, Canada, and Europe has been less than the growth in their GNP, the converse of our situation. And, even with surging exports to this market, output been increasing too slowly to cut into high rates of unemployment in Europe and elsewhere. As a consequence, the demand of others for our products has been relatively weak.

The strong competition from abroad has, in an immediate sense, had benefits as well as costs for this country. It has been a powerful force restraining prices in the industrial sector and in encouraging productivity improvement. The related net capital inflow has eased pressures on our interest rates and capital markets. We have been able to readily satisfy the higher levels of consumption driven in part by the budget deficit.

But those benefits cannot last. Sooner or later our external accounts will have to come much closer toward balance.

Indeed, as our debts increase, we will have to earn even more in our trade to help pay the interest.

In the meantime, the flood of imports, and the perceptions of unfairness which accompany it, foster destructive protectionist forces. The domestic investment we will ultimately need is discouraged while our companies shift more of their planned expansion overseas. And the larger the external deficits and the longer they are prolonged, the more severe the subsequent adjustments in the exchange rate and in our economy are apt to be. We will have paid dearly indeed for any short-term benefits.

These considerations have tempered the conduct of monetary policy for some time. Specifically, our decisions with respect to providing reserves and reducing the discount rate have been influenced to some extent by a desire to curb excessive and ultimately unsustainable strength in the foreign exchange value of the dollar. But we have also had to recognize the clear limitations and risks in such an approach.

The possibility at some point that sentiment toward the dollar could change adversely, with sharp repercussions in the exchange rate in a downward direction, poses the greatest potential threat to the progress we have made against inflation. Those risks would be compounded by excessive monetary and liquidity creation.

As I have said to this Committee before, there is little doubt that the dollar could be driven lower by "bad" monetary policy -- a policy that poses a clear inflationary threat of its own and undermines confidence. But such a policy could hardly be in our overall interest -- it would in fact be destructive of all that has been achieved.

The hard fact remains that so long as we run massive budgetary deficits, we will remain dependent on unprecedented capital inflows to help finance, directly or indirectly, that deficit. The net capital inflows will be mirrored in a trade deficit -- they are Siamese twins.

As things now stand, if our trade deficit narrowed sharply, both the budget deficit and investment needs would have to be financed internally, with new pressures on interest rates and a squeeze on other sectors of the economy -- some of which are now doing relatively well, such as housing, and some, such as farmers and thrift institutions, already under strong financial pressure. The implications for our trading partners and for the heavily indebted developing countries would be severe as well.

There has to be a way out of the impasse -- a way that would maintain and even enhance confidence in our own economy and prospects for stability, a way that would not simply shift the pressures from one sector of the economy to another, and a way consistent with the economic growth of other countries. But that way cannot be found by U.S. monetary policy alone.

What we can do is reduce our dependence on foreign capital, and the rising imports to meet our domestic demands, by curtailing the budget deficits that importantly drive the process. In that sense, the choice is before you -- in the decisions you will make in the budgetary deliberations that have been so prolonged.

The needed adjustments would be eased as well if other industrialized countries became less dependent on stimulus from the United States for growth in their own economies.

I am a central banker. I can well appreciate and sympathize with the priority that those countries have attached to budgetary restraint and particularly to the need to restore a sense of price stability in their own economies. They have had a large measure of success in those efforts in the face of depreciation of their currencies vis-a-vis the dollar, which has made the process more difficult. The pull of capital into the United States, and the reduced outflow from the United States, has also had effects on their own financial markets and interest rates,

and thus on the possibilities for "home grown" expansion. But as those adverse factors diminish in force, or even begin to be reversed, opportunities surely exist for fostering more expansion at home, in their own interest as well as that of a better balanced world economy.

All of the industrialized countries, working with the International Monetary Fund, the World Bank, and by other means, need to continue to support the efforts of much of the developing world to restore the financial and economic foundations for growth in their countries. That process, under the pressure of the "debt crisis," has been underway for some years. By its nature, the fundamental adjustments required pose challenging questions of economic and political management. There is a certain irony in observing the enormous difficulties in our own political process in achieving -- so far without success -- deficit reductions equivalent to one to two percent of our GNP while much poorer countries with much

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greater demands upon them are cutting their deficits by much larger relative amounts.

That effort -- along with others -- is justified only by its necessity to their own economic health. It is hardly surprising that progress has been uneven, that from time to time setbacks are encountered, and that impatience and frustration surface politically. But I know of no realistic shortcuts or substitutes for the effort to place their own economies on a sounder footing, any more than we can ultimately escape our own responsibilities to put our budget in order.

What is so encouraging is that the strong effort that has been made in most of the indebted countries is yielding some tangible results. A measure of growth has been restored in Latin America as a whole. With interest rates lower and many debts restructured, debt burdens are gradually but measurably being reduced.

For the most part, the heavily indebted countries are still a long way from regaining easy access to commercial

credit markets. Extraordinary cooperative efforts by the IMF, the World Bank and commercial banks will continue to be required for a time to make sure external financing obligations are structured in a way that matches ability to pay. As always, the ultimate success of all those efforts -- most of all those by the borrowers themselves -- will depend upon orderly growth, reasonable interest rates, and access to markets in the rest of the world, which will be determined by our actions and those of our trading partners.

Conclusion

We have had a relatively strong economic expansion in the United States over the past 2-1/2 years as a whole. At the same time, the rate of inflation has remained at the lowest level in more than 15 years. That combination should be a source of great satisfaction. But 2-1/2 years is not, in itself, terribly significant in the economic life of the nation. What will count is whether we can build on that progress, and extend it over a long time ahead.

The inherent strength of our economy and the momentum of our expansion have carried us a long way. We have done a lot to lead the world to recovery. The longer-term opportunities are still there for the taking. But we also do not need to look far to see signs of strain, imbalance, and danger.

In these circumstances, monetary policy has accommodated a sizable increase in monetary and credit growth, and interest rates have dropped appreciably even though they are still relatively high in real terms. In that way, economic growth has been supported at a time when the dollar has been particularly strong and inflationary pressures, at least in contrast to the 1970s and early 1980s, quiescent. But there are obvious limitations to the process of monetary expansion without threatening the necessary progress toward stability upon which so much rests.

Plainly, there are implications for other policies as well.

The widely shared sense that other nations should do more to open markets, to deal with the structural rigidities in

their economic systems, to encourage growth -- to get their own houses in order -- is certainly right. We can legitimately cajole, and urge, and bargain to those ends.

But there can also be no doubt that it all will come much easier as the United States does its part. Monetary policy must be part of that effort. But we also do need to come to grips with the budget deficit. We do need to avoid a witch's brew of protectionism.

The success of the world economy -- and of our fortunes within it -- is in large measure dependent on us. That is the inescapable consequence of size and leadership.

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Table I

Economic Projections for 1985 and 1986*

| | FOMC Members and other FRB Presidents | |
|---|---|---|
| | Range | Central Tendency |
| **1985** | | |
| Percent change, fourth quarter to fourth quarter: | | |
| Nominal GNP | 6-1/4 to 7-3/4 | 6-1/2 to 7 |
| Real GNP | 2-1/4 to 3-1/4 | 2-3/4 to 3 |
| Implicit deflator for GNP | 3-1/2 to 4-1/4 | 3-3/4 to 4 |
| Average level in the fourth quarter, percent: | | |
| Unemployment rate | 6-3/4 to 7-1/4 | 7 to 7-1/4 |
| **1986** | | |
| Percent change, fourth quarter to fourth quarter: | | |
| Nominal GNP | 5-1/2 to 8-1/2 | 7 to 7-1/2 |
| Real GNP | 2 to 4 | 2-1/2 to 3-1/4 |
| Implicit deflator for GNP | 3 to 5-1/2 | 3-3/4 to 4-3/4 |
| Average level in the fourth quarter, percent: | | |
| Unemployment rate | 6-3/4 to 7-1/2 | 6-3/4 to 7-1/4 |

*The Administration has yet to publish its mid-session budget review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals has not been included in this report.

Table II

Long-run Growth Ranges for the Aggregates
(Percent increase, QIV to QIV unless otherwise noted)

| | Adopted in February for 1985 | Adopted July 1985 | |
|---|---|---|---|
| | | 1985 | Tentative for 1986 |
| M1 | 4 to 7 | 3 to 8 1/ | 4 to 7 |
| M2 | 6 to 9 | 6 to 9 | 6 to 9 |
| M3 | 6 to 9-1/2 | 6 to 9-1/2 | 6 to 9 |
| Domestic Non-financial debt | 9 to 12 | 9 to 12 | 8 to 11 |

1/ Annual rate of increase over the period from QII 1985 to QIV 1985.

Chart 1

## M1 Growth Ranges and Actual

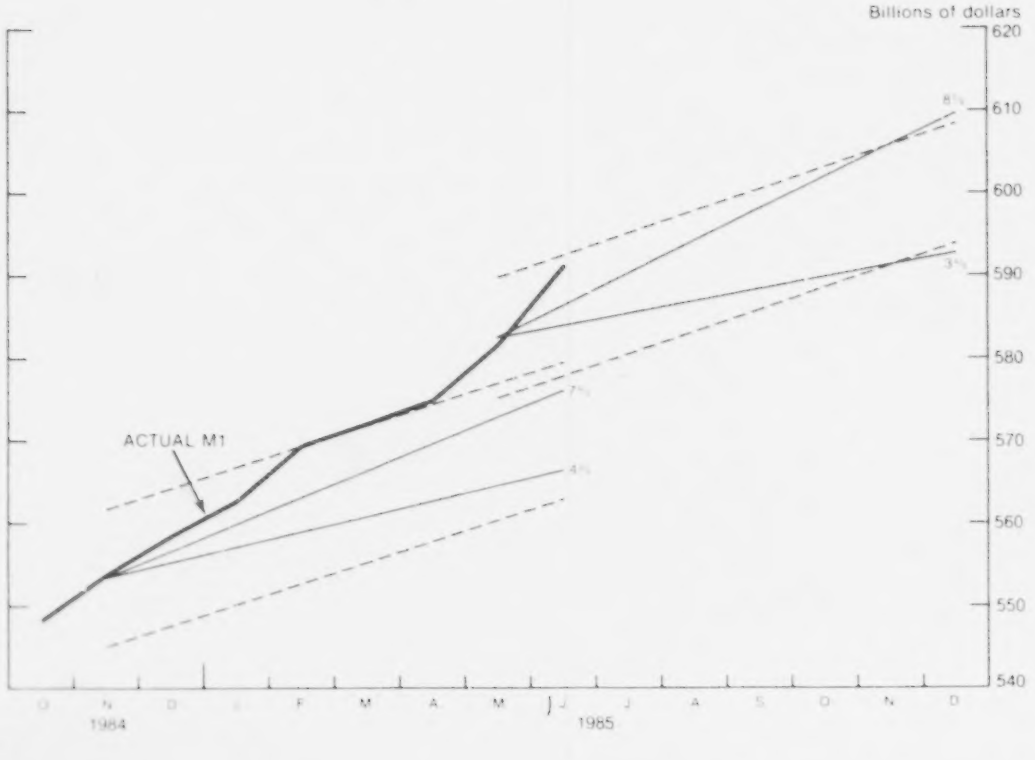


Chart 2

## M2 Growth Range and Actual

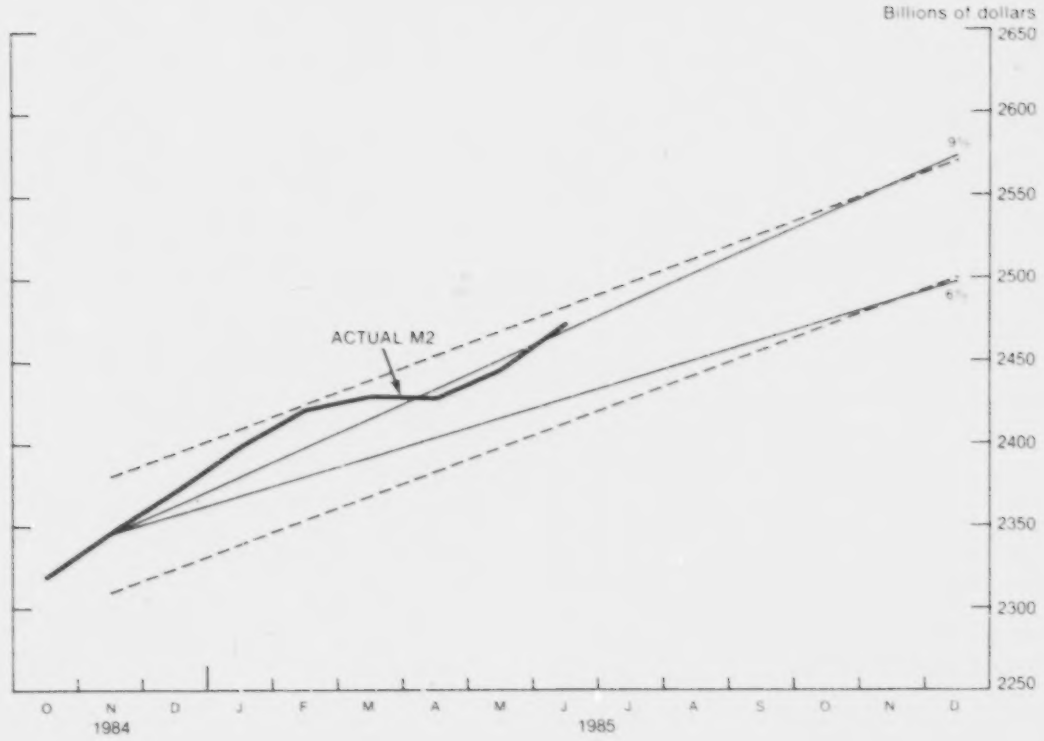


Chart 3

## M3 Growth Range and Actual

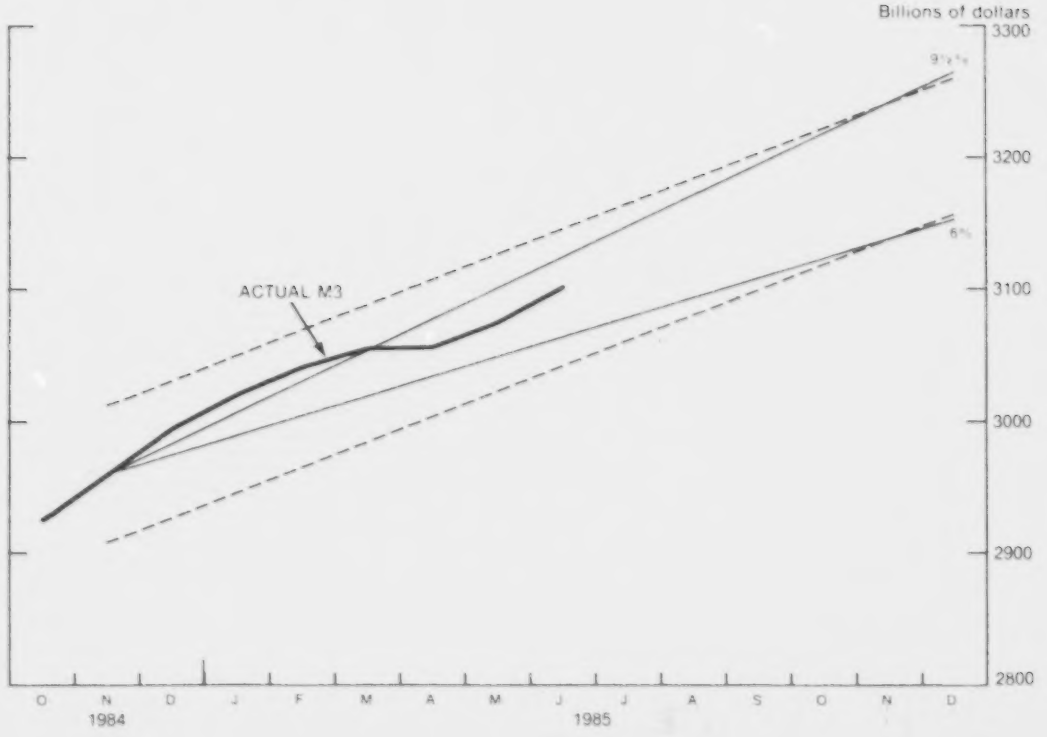
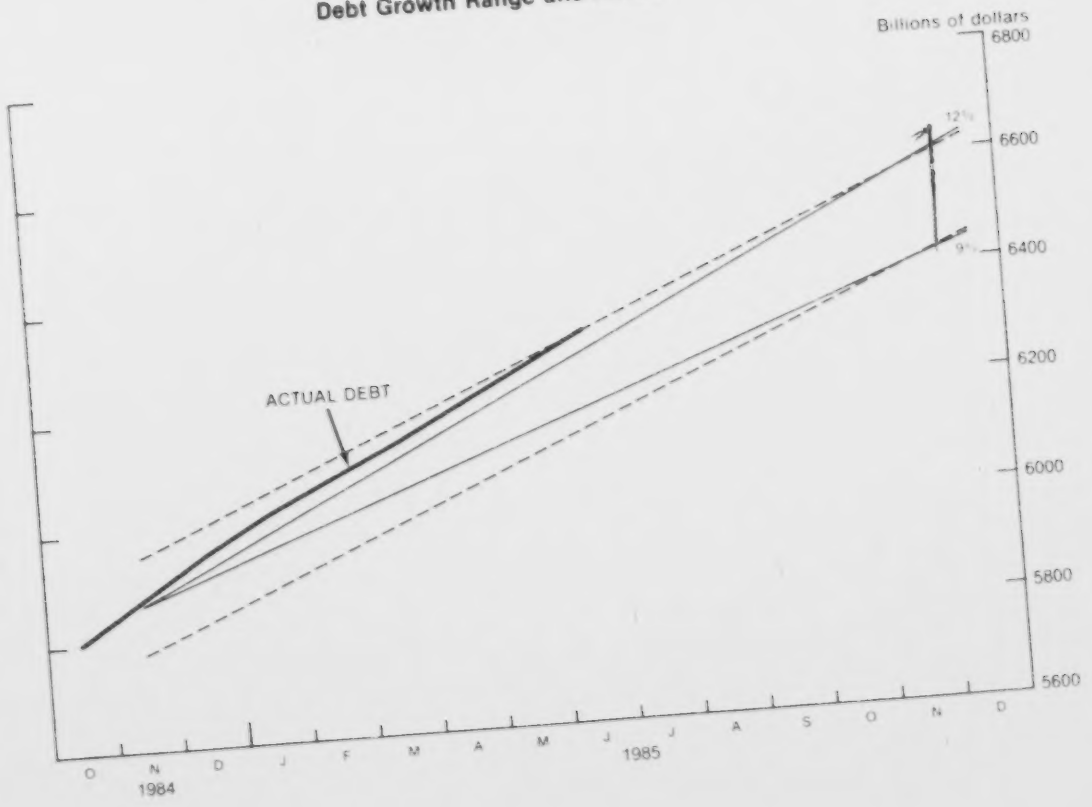


Chart 4

## Debt Growth Range and Actual



**For use at 4:30 p.m., E.D.T.**
**Tuesday**
**July 16, 1985**

Board of Governors of the Federal Reserve System

# Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

July 16, 1985

## Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 16, 1985

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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Section 1. Monetary Policy and the Economic Outlook for 1985 and 1986

The fundamental objective of the Federal Reserve in charting a course for monetary and debt expansion remains unchanged--to foster a financial environment conducive to sustained growth of the economy, consistent with progress over time toward price stability. In working toward those goals, developments with respect to the dollar and our external position have necessarily assumed greater prominence. More generally, while policy initiatives are stated in terms of growth rates of certain monetary and credit aggregates, the Federal Open Market Committee has emphasized the need to interpret those aggregates in the light of other information about the economy, prices, and financial markets. Moreover, the monetary targets for 1985 needed to be evaluated, and in the case of M1 adjusted, in light of the unusual and unexpected behavior of GNP relative to money during the first half of this year.

Economic and Financial Background

Economic activity continued to expand during the first half of 1985, but at a relatively slow pace. Real gross national product probably increased at an annual rate of less than 2 percent, falling short of the expectations of many forecasters and of the rate anticipated for the year by members of the Federal Open Market Committee when they formulated their annual monetary policy plans in February. While the economic environment was conducive to the containment of inflation within the 3-1/2 to 4 percent range of the past few years, there has been no further progress toward full employment of the nation's labor resources or industrial capacity. Indeed,

the unemployment rate has remained at about 7-1/4 percent, well below the peak of the 1981-82 recession, but still an historically high level.

The slowing of output growth, which began in the middle of 1984, has brought into sharper focus the unevenness of this business expansion and the significance of some basic structural imbalances in the economy. The federal budget deficit has remained in the neighborhood of $200 billion, rather than moving in the direction of balance as might normally be expected in the course of an upswing in economic activity. The heavy demands placed on the credit markets by the Treasury's financing activities have, in turn, been one factor helping to hold real interest rates at historically high levels. And those high rates have contributed to the strong demand of international investors for dollar-denominated assets and thus to the strength of the dollar on foreign exchange markets.

Although the dollar was little changed on balance over the first half, with a spike in its value early in the year being subsequently reversed the adverse effects on the U.S. trade position of the appreciation of the preceding several years, together with slow economic growth abroad, were very much in evidence. U.S. firms continued to face severe competitive pressures, and our exports fell while our imports rose. The widening current account deficit was mirrored in the continuing gap between the growth of domestic spending and domestic production. Moreover, the effects of this imbalance were felt with particular severity in the manufacturing, mining, and agricultural sectors of the economy, where profitability was squeezed overall and employment declined.

The lagging growth of production, relatively well contained inflationary pressures on resources, and the high value of the dollar on exchange

markets provided the backdrop for the conduct of monetary policy in the past several months. Reserves available to the banking system expanded substantially over the first half of the year, and the discount rate was cut by one-half percent in the spring. With the economic expansion slowing, interest rates--which had declined sharply from the summer of 1984 to early 1985--dropped somewhat further on balance by mid-year.

The declines in market interest rates in the latter part of last year and this year had substantial effects, lasting for a number of months, on the demands for assets contained in M1. Some savings apparently were shifted into interest-earning checking accounts (NOW accounts) from other instruments, and demand deposits also rose, as the cost of holding these accounts in terms of earnings forgone was reduced. As a result of the shifts of funds, M1 expanded at about a 10-1/2 percent annual rate over the first half of the year (measured from the fourth quarter of 1984 to the second quarter of 1985), well above the 4-to-7 percent range established by the FOMC in February. At the same time, however, the broader monetary aggregates remained within their designated ranges. Over the period, M2 and M3 expanded at 8-3/4 and 8 percent annual rates, respectively, as compared with their growth ranges of 6 to 9 and 6 to 9-1/2 percent. Growth in domestic nonfinancial sector debt over the first two quarters of the year was a little above its 9-to-12 percent monitoring range, as debt issued to finance mergers and otherwise retire stock issues continued stronger than earlier expected.

The rapid growth of M1 in the first half of the year was accompanied by a sharp drop in the velocity of the aggregate: M1 velocity--the ratio of nominal GNP to money--declined at about a 5 percent annual rate.

In some respects, that development is reminiscent of experience in 1982-1983, when a large drop in interest rates also was accompanied by a marked decline in M1 velocity, with the attractiveness of M1-type balances enhanced by the availability of explicit interest on NOW accounts. There is evidence from recent experience, as well as from research on the interest responsiveness of the demand for money, suggesting that such episodes might be expected as the economy and financial markets adjust over time to further progress toward price stability and as the inflation premium in interest rates consequently diminishes. As this occurs, likely in unpredictable spurts, the public's demand for M1 will tend to rise and the level of M1 velocity could drop more or less "permanently." However, there will be uncertainty about such a conclusion until it becomes apparent in the period ahead whether velocity is returning toward trend or whether it is tending to rise rapidly because the public is reducing its "excess" money balances by spending or investing them; in the latter case, the drop in velocity in the past two quarters could be reversed to some extent.

The recent developments affecting M1 illustrate the still considerable uncertainties about the shorter-run behavior and trend of its velocity. Over the last three and a half years, the income velocity of M1 actually has declined slightly on balance. In contrast, over the preceding three decades, velocity had increased by more than 3 percent per year, on average. Velocity changes are influenced by the behavior of interest rates, but the extent of interest rate impact is variable and may be changing as the public and depository institutions adjust to the new deposit instruments and deregulation of deposit ceiling rates of recent years. Moreover, the underlying trend of

velocity will also be influenced by the rate of financial innovation. While that may slow down once the adjustment is made to a deregulated environment and with lower interest rates, increased computerization could also work toward a rise in velocity over time as the efficiency of the payments system increases.

Ranges for Money and Debt Growth in 1985 and 1986

In reexamining its M1 range for 1985, and in setting a tentative range for 1986, the Committee expected that velocity, after its sharp decline in the first half of this year, would cease falling rapidly--while recognizing that much of the recent decline may not be reversed. Allowance also needed to be made for the high degree of uncertainty surrounding the behavior of M1 velocity, given the experience of the past few years. To take account of these considerations, the base for the range of M1 was shifted forward to the second quarter of 1985, and the range was set to encompass growth at a 3 to 8 percent annual rate over the second half of this year. This range contemplates a substantial slowing in growth from the pace of the first half, and the lower part of the range implies a willingness to see relatively slow growth should the recent velocity decline be reversed and economic growth be satisfactory.

The appropriateness of the new range will be under continuing review in light of evidence with respect to economic and financial developments, including conditions in foreign exchange markets. It was noted that, because of the burst of money growth in June, the current level of M1 is high relative to the new range. The Committee expected that the aggregate

would move into the new range gradually over time as more usual behavior of velocity emerged.

For 1986, the M1 range was tentatively set at 4 to 7 percent. The Committee recognized that uncertainties about interest rates and other factors that could affect velocity would require careful reappraisal of the range at the beginning of that year. In addition, it was noted that actual experience with institutional and depositor behavior after the completion early next year of deposit rate deregulation would need to be taken into account in judging the appropriateness of the ranges. At the beginning of next year, regulatory minimum balance requirements on Super NOW accounts and money market deposit accounts will be removed, and at the end of March 1986, deposit ceiling rates will be lifted entirely, affecting savings deposits and regular NOW accounts.

The table below summarizes decisions with respect to the ranges of growth for the aggregates for 1985 and 1986. Except for M1 in 1985, the growth ranges apply to one-year periods measured on a fourth quarter to fourth quarter basis. The M1 range for 1985 applies to the second half of the year, as noted above.

Ranges of Growth for Monetary and Debt Aggregates
(Percent change)

| | 1985 | Tentative for 1986 |
|---|---|---|
| M1 | 3 to 8* | 4 to 7 |
| M2 | 6 to 9 | 6 to 9 |
| M3 | 6 to 9-1/2 | 6 to 9 |
| Debt | 9 to 12 | 8 to 11 |

* Applies to period from second quarter to fourth quarter.

With respect to the broader monetary and credit aggregates, the Committee reaffirmed the 1985 ranges for M2, M3, and domestic debt that had been established in February. It is recognized, as at the start of the year, that actual growth over the four quarters of 1985 might be toward the upper parts of the ranges, and it was felt that this would be acceptable, depending on developments in the velocities of the various measures, as long as inflationary pressures remained subdued.

The tentative ranges for 1986 for M3 and total debt embody reductions from 1985--in the case of debt by a full percentage point and in the case of M3 by one-half percentage point on the upper limit. The range for M2 was left unchanged. In the case of the monitoring range for debt, it was assumed that, while debt might well continue its tendency of recent years to grow considerably faster than GNP, its expansion would be tempered by a drop-off in the net redemption of equity shares that has boosted corporate credit use dramatically in the past year or two.

Economic Projections

All the monetary ranges specified were felt to be consistent with somewhat more rapid economic growth than characterized the first half of the year, as long as inflationary pressured remain contained. At the same time, Committee members felt that the present circumstances in the economy contain particular risks and uncertainties that can imperil progress over the next year and a half toward either growth or price stability. Clearly, the serious imbalances referred to earlier in this section cannot be remedied through the actions of the central bank alone. Attainment of fully satisfactory economic performance and minimization of risks will require timely action in other areas of policy, here and abroad.

The economic projections of the members of the FOMC, as well as of the Reserve Bank Presidents who are not at present members of the Committee, are summarized in the table on the next page. The central tendency of the forecasts for real GNP points to some pickup in the pace of expansion in the second half of this year. The expected strengthening, given the slow growth in the first half, still would leave the GNP expansion for the year as a whole short of the range reported by the Federal Reserve in February, and below the forecasts published by the Administration to date.

The FOMC members and the other Reserve Bank Presidents expect growth in the 2-1/2 to 3-1/4 percent range during 1986. Such a rise in output is seen as entailing substantial gains in employment, enough to bring about a small decrease in the civilian unemployment rate, to around 7 percent by the end of next year. With pressures in labor and product markets limited, most FOMC members and other Presidents foresee only a marginal increase, if any, in the rate of inflation, in 1986. It should be noted, however, that these projections are based on an assumption that exchange value of the dollar will not deviate substantially from its recent levels.

The projections for a pickup in GNP growth over the reduced rate of the first half of this year are based in part on the expectation that the declines in interest rates (and concomitant rise in stock prices) that have occurred over the past few quarters will be providing impetus to demand for goods and services in the months ahead. Consumer attitudes toward spending appear favorable, and housing activity already has shown improvement, although the FOMC members are somewhat concerned by the rising debt burdens of households and the increasing payment problems suggested by figures on consumer

Economic Projections for 1985 and 1986*

| | FOMC Members and other FRB Presidents | |
|---|---|---|
| | Range | Central Tendency |
| **1985** | | |
| Percent change, fourth quarter to fourth quarter: | | |
| Nominal GNP | 6-1/4 to 7-3/4 | 6-1/2 to 7 |
| Real GNP | 2-1/4 to 3-1/4 | 2-3/4 to 3 |
| Implicit deflator for GNP | 3-1/2 to 4-1/4 | 3-3/4 to 4 |
| Average level in the fourth quarter, percent: | | |
| Unemployment rate | 6-3/4 to 7-1/4 | 7 to 7-1/4 |
| **1986** | | |
| Percent change, fourth quarter to fourth quarter: | | |
| Nominal GNP | 5-1/2 to 8-1/2 | 7 to 7-1/2 |
| Real GNP | 2 to 4 | 2-1/2 to 3-1/4 |
| Implicit deflator for GNP | 3 to 5-1/2 | 3-3/4 to 4-3/4 |
| Average level in the fourth quarter, percent: | | |
| Unemployment rate | 6-3/4 to 7-1/2 | 6-3/4 to 7-1/4 |

*The Administration has yet to publish its mid-session budget review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals has not been included in this report.

and mortgage loan delinquencies. In the business sector, inventory overhangs appear to be limited in scope and degree, and fixed investment seems to have picked up a little after exhibiting some weakness earlier this year; the lower cost of capital and desires to cut costs and maintain competitiveness are expected to keep investment on a moderate uptrend, even though pressures on capacity may not be great. Spending by the federal government and by states and localities is expected to grow rather slowly.

A key ingredient in many of the projections is the expectation that there will be a tendency in the coming year for our external position to stabilize, so that domestic production will more fully reflect the expansion of domestic demand. Developments in this area will, of course, depend in part on the course of economic expansion abroad. Were the U.S. external position to continue deteriorating as it has been, the sectoral imbalances in the economy would be exacerbated, creating further difficulties for many companies, their employees, and their communities. The draining off of income would jeopardize the sustainability of economic expansion, and the risks of economic and financial dislocations would intensify.

The FOMC members and other Presidents also assumed in their policy deliberations and in the projections that the Congress and the Administration would achieve deficit reductions in the range of those in the recent House and Senate budget resolutions. Failure to move forward with those proposals would run a serious risk of reversing the favorable effects that congressional actions to date have had on investor expectations, and would create a real impediment to the solution of the structural problems plaguing our economy today.

Section 2: The Performance of the Economy in the First Half of 1985

After a year and a half of extraordinarily rapid growth, economic activity decelerated abruptly in the middle of 1984, and slowed somewhat further in the first half of 1985. Growth in real gross national product is estimated to have averaged less than 2 percent at an annual rate so far this year; the unemployment rate has remained flat at about 7-1/4 percent. Inflation has held at the lower pace reached during the 1981-82 recession.

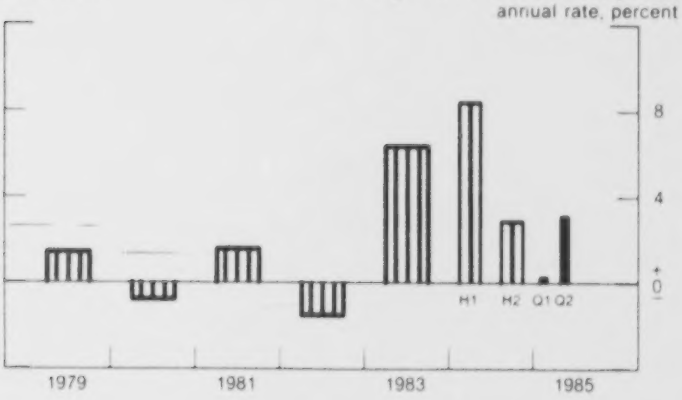
To some extent, the moderation in growth during the past year has reflected the slowing in household and business spending that often occurs after the initial phase of cyclical recovery. Pent-up demand for housing and consumer durables generally fades as an expansion period lengthens, and growth in business fixed investment often exhibits some cyclical deceleration over time. However, the recent slowing in growth also reflects factors unique to this expansion.

In particular, this expansion has taken place in the context of a highly stimulative federal fiscal policy. Real GNP grew more rapidly in 1983 and the first half of 1984 than in any previous recovery since the Korean War. Ultimately, some slowing in growth would have been required to avoid inflationary overheating of the economy. However, even before that point was reached, the initial effect of the fiscal stimulus began to wane, dissipated in part through its contribution to a worsening U.S. competitive position in international trade and diversion of demand away from goods produced in the United States.

The pronounced increases in the merchandise trade and current account deficits have occurred as enormous federal deficits and resultant

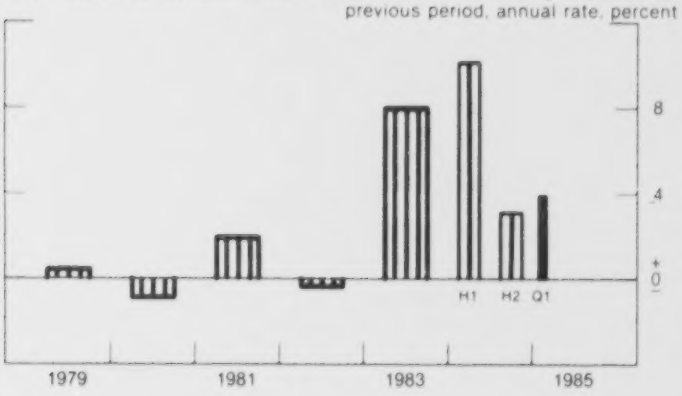
**Real GNP**

Change from end of previous period, annual rate, percent



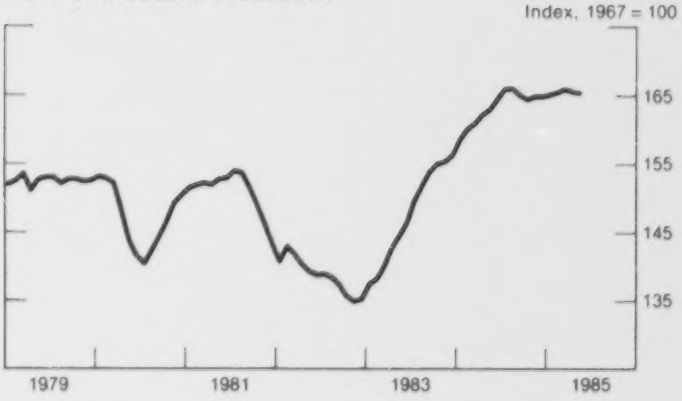

**Real Gross Domestic Purchases**

Change from end of previous period, annual rate, percent




**Index of Industrial Production**

Index, 1967 = 100



heavy borrowing by the federal government have added to other factors helping to keep U.S. interest rates at high levels, relative both to historical experience and to the rate of inflation. These credit demands have been met partly through a substantial inflow of foreign capital, which has been associated with a large appreciation in the foreign exchange value of the U.S. dollar. The strong dollar has encouraged U.S. consumers and businesses to increase greatly the portion of their expenditures devoted to imports, and at the same time has inhibited U.S. exports. Exports also have been restrained by slow growth in demand abroad. As a result, gains in domestic demand have outstripped those in domestic production by a wide margin throughout the expansion period.

The effects of the weakening trade balance in the past few years have been felt keenly in the manufacturing sector. Industrial production, which began to level off in the summer of 1984, remained stagnant in the first half of 1985, and employment in the manufacturing sector declined. The strong dollar also has exacerbated the economic problems of farmers, many of whom face difficult adjustments because of falling product prices and the need to service a large volume of debt accumulated during the inflationary period of the 1970s and early 1980s.

Thus far, however, the weakness in the manufacturing and agricultural areas has been more than offset by strong gains in other sectors. Domestic final demand rose at a 3-1/2 percent annual rate in the first quarter of 1985, about the same as in the second half of last year; second-quarter gains appear also to have been substantial. Spending in such interest-sensitive areas as autos and housing was particularly strong

in the first half of 1985, reflecting in part lower credit costs that have emerged since mid-1984.

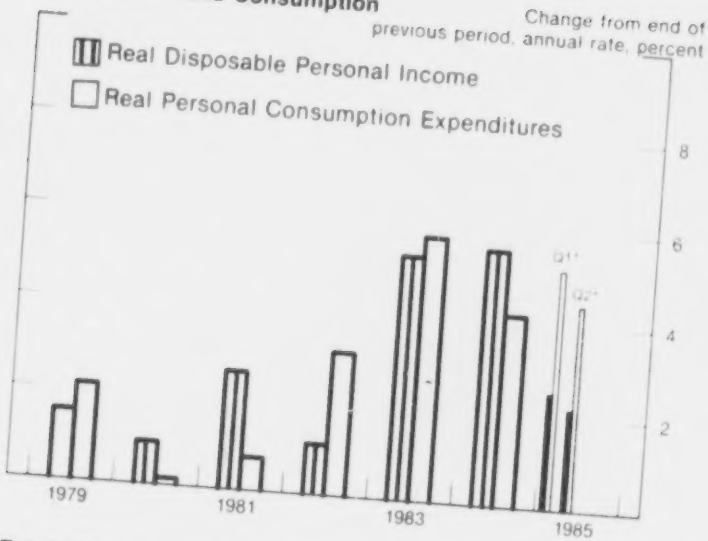
The strength of the dollar also has had a restraining influence on inflation, by reducing import prices and by forcing U.S. producers to adopt more competitive pricing strategies. Inflationary pressures have been limited, too, by the lack of pressure on resources here and the slack abroad. Most measures of overall price increase remained in the 4 percent range in the first half of 1985, but prices of manufactured goods rose little and significant downward pressures on prices were evident in markets for oil and basic commodities.

The Household Sector

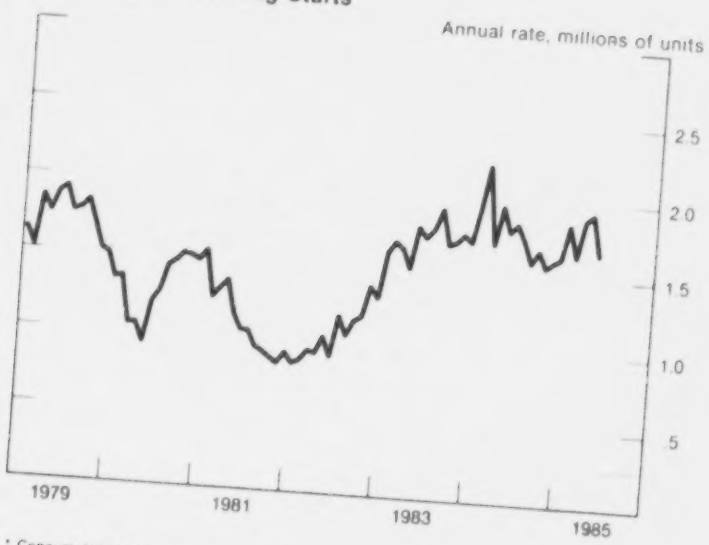
Growth in real disposable income continued to slow in the first half of 1985, reflecting smaller increases in interest income as well as weakness in manufacturing payrolls and farm income. Nonetheless, gains in household spending, especially in the interest-sensitive sectors, were sizable, supported by continued heavy borrowing. As a result, the personal saving rate fell appreciably below last year's 6 percent level.

Consumer spending for new cars was particularly strong in the first half. Total auto sales averaged nearly 11 million units at an annual rate, with sales of domestic models around their highest level for a six-month period since 1979. The strength in auto sales was partly attributable to the improved availability of many popular domestic models since the strike-related disruptions in production last fall. In addition, auto demand was bolstered by generally lower interest rates compared with last year and by some special financing programs offered by manufacturers. Sales of foreign cars were

**Real Income and Consumption**




**Total Private Housing Starts**




* Consumption and income growth for 1985 Q2 are based on April and May data. Income in both 1985 Q1 and 1985 Q2 has been adjusted for tax refund delays.

held down in the first quarter because supplies of Japanese models were limited at the end of the annual period for the voluntary export restraint program. However, foreign car sales picked up in the spring and early summer when Japanese cars shipped after the start of the new annual period began to arrive at U.S. dealerships.

Meanwhile, activity in the housing market has rebounded since last fall. Housing starts rose to a 1.8 million unit annual rate on average in the first five months of 1985, retracing nearly all of the decline that occurred in the latter half of last year after rates on fixed-rate mortgages temporarily rose to the 14 percent range. Housing activity generally has been quite robust in this expansion period, despite high real interest rates. Demand for owner-occupied units has been buoyed by the movement of the "baby-boom" generation into its prime home-buying years, as well as by the beneficial effects of stable house prices and innovative financing techniques such as adjustable-rate mortgages on the affordability of homes.

The strong gains in household spending over the past two and a half years have been accompanied by considerable alterations in balance sheets. The ratio of household debt to income has increased rapidly, and is now well above its 1980 peak. However, asset growth has been strong as well, and the ratio of financial assets to income has risen sharply in the past year, owing in part to the rapid rise in stock prices.

The incidence of payment difficulties on consumer installment debt has risen somewhat in the past half year or so, from relatively low levels. Delinquency and foreclosure rates on home mortgages have been at high levels for some time, and they rose further in early 1985. The large number of

defaulted mortgage loans partly reflects the still high rates of unemployment and the weakness of home prices in many locales, which has left some homeowners with little equity to protect when they encounter financial difficulties. However, aggressive underwriting of some mortgages, including loans carrying lower payments in the first years, appears to be a contributing factor.

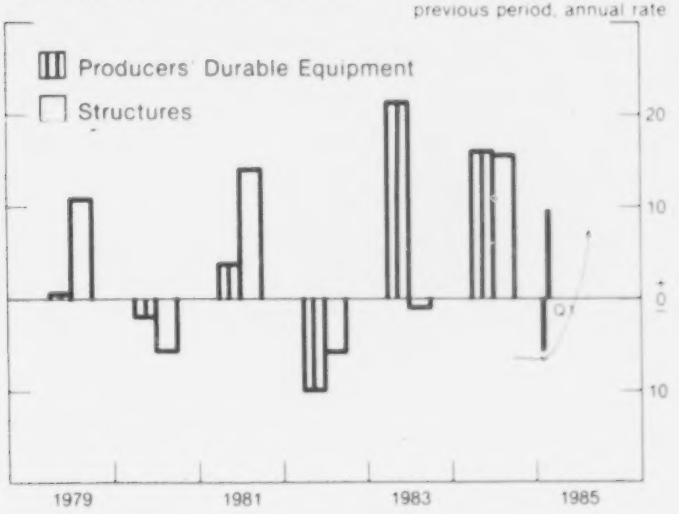
The Business Sector

Conditions in the business sector were mixed in the first half of 1985. Many industrial firms experienced pressures on profit margins in an environment of intense price competition and declining capacity utilization, and widespread financial strains continued to be present in the agricultural and energy sectors. At the same time, however, some other sectors of the economy recorded good gains in sales and income. Economic profits for corporations in the aggregate remained at the higher level reached after the sharp runup earlier in the expansion, with after-tax profits as a percent of GNP at the highest levels seen for any sustained period since the late 1960s.

Growth in business spending for fixed capital began to slow in the latter half of 1984, after a period of extraordinary expansion, and a further slowing occurred in the first part of 1985. The weakening has been most pronounced in equipment outlays, affecting both the high-technology categories and more traditional types of industrial equipment. Nevertheless, surveys of capital spending intentions taken in the first half of the year indicated that businesses still planned a healthy expansion in outlays for 1985 as a whole. A relatively large proportion of these expenditures reportedly was earmarked for replacement and modernization rather than

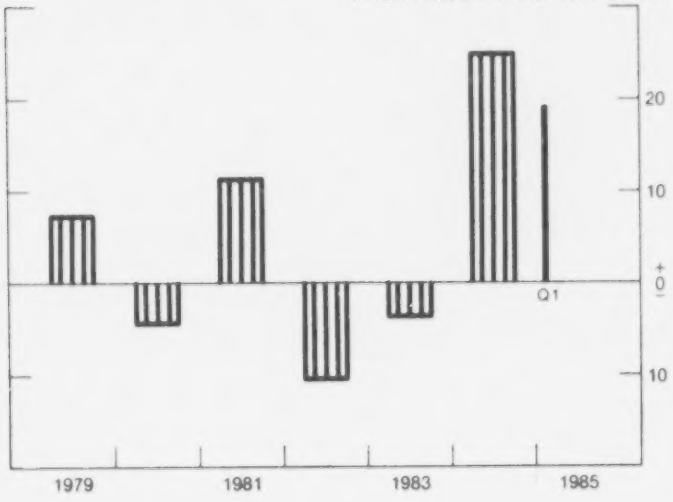
**Real Business Fixed Investment**

Percent change from end of previous period, annual rate




**Changes in Real Business Inventories**

Annual rate, billions of 1972 dollars



expansion of capacity, reflecting a desire to cut costs and improve competitiveness. Meanwhile, spending for nonresidential construction, particularly offices and stores, continued at strong rates in the first half of 1985, and construction contracts rose further despite very high vacancy rates in many parts of the country.

The pace of inventory accumulation in the business sector has been moderate in recent months. In real terms, business inventories rose about $19 billion at an annual rate in the first quarter of 1985, compared with an average gain of $25 billion in 1984; inventory accumulation probably was still lower in the second quarter. Manufacturers, especially those facing intense import competition, have continued to be cautious in adding to inventories. Total stocks in this sector declined in both April and May, and inventory-sales ratios for the most part remain near historical lows. In the trade sector--with the notable exception of the car industry--inventory-sales ratios have remained a bit high, though, and selected efforts to pare stocks have continued.

With slower growth in investment in the first half of 1985, the gap between capital expenditures and internal funds of firms remained moderate. Nevertheless, businesses continued to borrow heavily, reflecting a continued massive amount of equity retirements by firms engaged in mergers and other corporate restructurings. As a result, debt-equity ratios have risen for a number of firms, especially in the petroleum industry, where a major restructuring is currently taking place. However, for most other firms, equity additions through retained earnings or sales of new shares have been considerable. With rising stock prices, debt-equity ratios for

these firms, when their assets and liabilities are measured at current market values, have shown some decline in recent months.

Nonetheless, financial strains, in many cases related to the high foreign exchange value of the dollar, persist in some areas of the economy. In particular, low capacity utilization rates in a number of import-sensitive manufacturing industries, including machine tools, steel, some types of chemicals, and textiles have intensified pressures on profitability. In addition, large segments of the farm sector continue to suffer greatly from reduced exports, depressed land prices, and low incomes; many farmers face serious debt-servicing problems, causing problems in turn for agricultural lenders. In the energy sector, continued downward pressure on world oil prices has caused petroleum drilling to be curtailed, which has strained the earnings of many oilfield equipment and servicing firms.

The Government Sector

Federal tax receipts continued to rise substantially in the first half of 1985, but so too did outlays, and the fiscal year 1985 deficit likely will be around $200 billion. This represents about 5 percent of total GNP, and more than half of net private domestic saving. Federal purchases of goods and services, the part of federal spending that enters directly into GNP and constitutes about a third of total outlays, rose comparatively moderately in the first half of 1985; defense procurement, an area of rapid growth in spending over the past few years, grew at a reduced pace as outlays lagged more than is typical relative to appropriations. Real nondefense purchases (excluding the Commodity Credit Corporation) continued to be relatively flat.

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Purchases by state and local governments were essentially unchanged in the first quarter, but evidently rose in the second, as construction outlays increased significantly in the spring. States and localities, many of which had serious fiscal difficulties in the last recession, generally have been cautious in raising spending throughout this expansion period, though they have been endeavoring to address the problem of an aging infrastructure. The combination of spending restraint and improved revenues owing both to legislated tax increases and to rising incomes, has resulted in a substantial rise in the operating and capital account surpluses of state and local governments since 1982.

The External Sector

The external sector has come to play an increasingly important role in the U.S. economy. Merchandise imports have risen rapidly in this expansion, moving above 15 percent of real domestic expenditures on goods in the first half of 1985. The increase in import penetration has been widespread, occurring in both the consumer and capital goods sectors, as well as in industrial supplies.

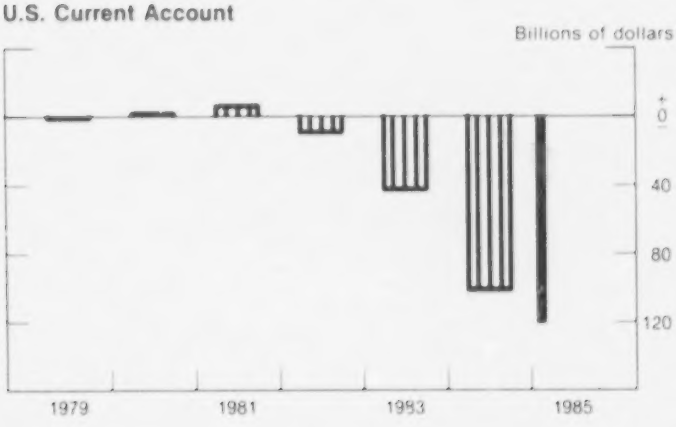
Although U.S. exports increased in 1983 and 1984, they grew much less than imports, and have not yet regained their previous peak. In the first half of 1985, exports, particularly of agricultural products, have declined somewhat. As a result of these trends, the current account deficit has widened dramatically over the past few years, reaching an annual rate of $120 billion in the first quarter of 1985.

Part of this imbalance reflects the stronger growth of demand in the U.S. economy since 1982 relative both to the other industrial countries

**Exchange Value of the U.S. Dollar**

**U.S. Real Merchandise Trade**

**U.S. Current Account**



and to the debt-burdened developing countries. Although this influence has lessened with the slowing of the U.S. economic expansion since the middle of last year, there has been no acceleration in growth in the other industrial countries, and many developing countries have continued to face financial constraints. The greater share of the imbalance, however, probably is attributable to the substantial appreciation of the dollar over the past few years. On average during the first half of this year, the trade-weighted value of the dollar was roughly 70 percent above its level five years earlier.

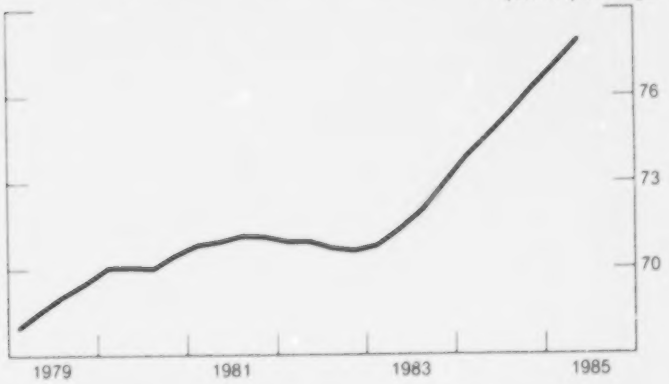
The appreciation of the dollar and the underlying demand of investors for dollar-denominated assets and other claims on the United States has been partly associated with differentials between real rates of return on U.S. and foreign assets. The enormous federal budget deficits have been an important factor contributing to these differentials. The moderation in interest rates that has accompanied the slowing of the economic expansion in the United States since mid-1984 appears to have eased some of the upward pressure on the dollar; after rising sharply through the first two months of this year, the exchange value of the dollar has trended downward and is now around the level of late last summer. Nevertheless, the high level of the dollar continues to limit the ability of U.S. producers to compete both at home and abroad.

Labor Markets

Growth in labor demand generally remained strong in the first half of 1985, and the number of workers on nonfarm payrolls increased 1.4 million. The bulk of the job growth was in the service and trade sectors, in which

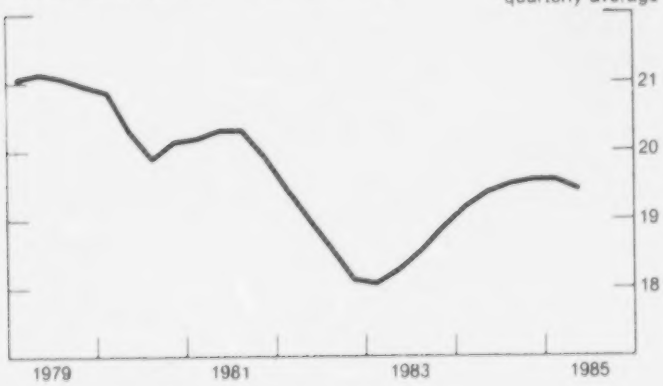
**Payroll Employment–Nonmanufacturing**

Millions of persons, quarterly average



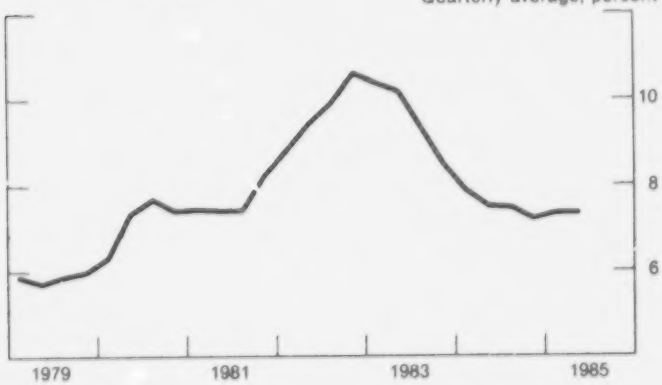

**Payroll Employment–Manufacturing**

Millions of persons, quarterly average




**Civilian Unemployment Rate**

Quarterly average, percent



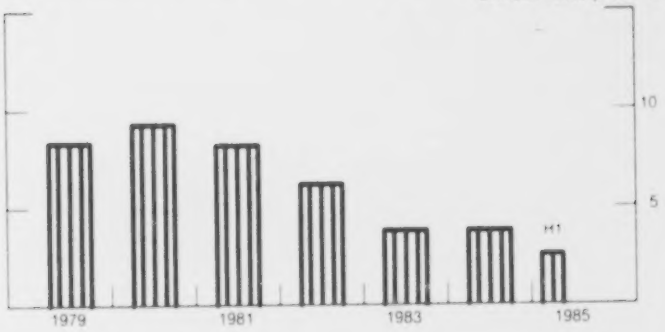
employment in the past six months has expanded at rates similar to last year's rapid pace. Increases in the restaurant and business services areas have been especially large. Construction employment also showed a sizable gain in the first half of 1985, along with significant growth in both residential and nonresidential construction. In contrast, manufacturing employment dropped about 220,000, with cutbacks in payrolls widespread among industries.

Despite the substantial gains in overall payroll employment, the unemployment rate has remained at about 7-1/4 percent, the level that has prevailed since last June. The labor force participation rate was up appreciably on average during the first half; the rise occurred primarily among adult women, who evidently were responding to the increase in job opportunities in the service and trade sectors, where 80 percent of adult women are now employed.

Wage inflation has remained restrained. Year-over-year changes in the employment cost index for wages and salaries, a relatively comprehensive measure for the private nonfarm business economy, have held steady at just over 4 percent for nearly a year. This is about one percentage point less than in 1983 and early 1984, and substantially below the peak rate of about 9 percent reached in 1980. The slowing in union wage increases over the past several years has been especially large. Union wage gains both in and out of manufacturing have been below the increases posted in nonunionized sectors for the past year and a half, causing a partial erosion of the differential that had built up over the years prior to the last recession. Major collective bargaining agreements negotiated in early 1985 indicate continued moderate wage growth in the unionized sectors.

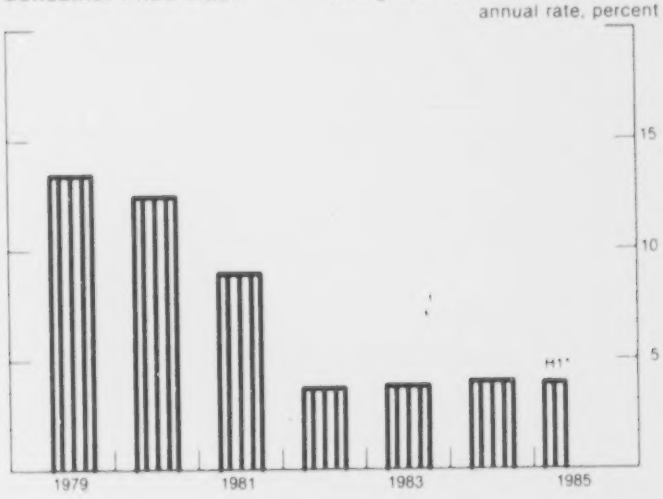
**Hourly Earnings Index**

Change from end of previous period, annual rate, percent



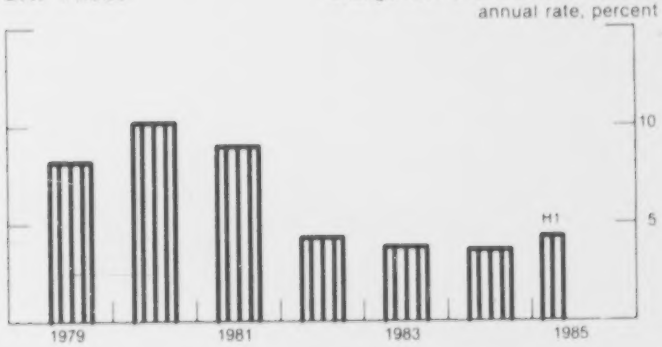

**Consumer Price Index**

Change from end of previous period, annual rate, percent




**GNP Prices**

Change from end of previous period, annual rate, percent




*Consumer price change for 1985 H1 is based on December to May period

Productivity in the nonfarm business sector appears to have declined in the first half of 1985, following increases amounting to 4 percent in 1983 and 2-1/2 percent in 1984. Both the recent slowing in productivity and the substantial gains earlier in the recovery largely reflect the fact that employment tends to respond more slowly than output to changes in demand. However, improvements in productivity appear to continue to be a major priority of both workers and management, as evidenced by widespread reports of modernization of facilities as well as relaxation of work rules and other steps to enhance efficiency and hold down costs.

The combination of improved productivity growth and relatively restrained wage gains in this expansion has resulted in a sizable deceleration in the average rate of increase in unit labor costs relative to the previous several years. Although unit labor costs have risen this year in response to the downturn in productivity, they are still only about 3 percent above their year-ago level.

Price Developments

After slowing sharply in the recession, the broadest measures of inflation have held fairly steady at about 4 percent during much of the expansion. While the stability of the inflation rate during this expansion partly reflects some special factors, significant progress appears to have been made in reversing the underlying momentum of the inflationary process that sustained the wage-price spiral of previous years. Inflation expectations have been more subdued, and both labor and management have exhibited a better appreciation of the fact that gains in real incomes cannot be achieved simply by marking up nominal wages or prices.

The strong dollar has reinforced other factors holding down inflation in this expansion period, both directly by reducing the prices of imported goods and indirectly by forcing U.S. manufacturers to restrain price increases in order to remain competitive. Retail prices of goods excluding food and energy rose about 3-1/2 percent, at an annual rate, in the first half of 1985, about the same as the average rate of change in the two preceding years. Increases in prices of nonenergy services, which have not been affected nearly as much by import competition, have continued to be substantial, averaging a 5-1/2 percent rate in the last six months, the same as in 1984.

Energy prices have been quite volatile over the past year, mainly reflecting movements in gasoline prices. From the autumn of 1984 through February of this year, gasoline prices fell by about 3-1/2 percent, as refiners sought to reduce excess inventories. Production was adjusted downward as well, resulting in a spurt in prices in the spring. However, gasoline prices appear to have stabilized more recently, as inventory levels have returned to normal while crude oil supplies remain abundant. Food prices have risen only a little this year, reflecting the moderate rate of increase in processing costs as well as plentiful agricultural supplies.

Prices of basic industrial commodities, which rose markedly in the initial stages of this upswing in business activity, have been trending downward for the past year and a half. The demand for materials by U.S. manufacturers has been weak, and world supplies have been ample, owing in part to the expansion of capacity in many developing countries in the past decade and their need to maintain export revenues.

Section 3: Money, Credit, and Financial Markets in the First Half of 1985

In February of this year, the FOMC established target growth ranges for the year (measured from the fourth quarter of 1984 to the fourth quarter of 1985) of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9-1/2 percent for M3. For domestic nonfinancial sector debt, an associated monitoring range was set at 9 to 12 percent. The M1 range for 1985 represented a one percentage point reduction at the upper end from the range of the preceding year, while the range for M2 was unchanged. To reflect changes in the pattern of financial flows, the 1985 range for M3 was raised by a half point at the upper end, and the whole range for the debt aggregate was raised by a percentage point. It was expected that these ranges would be adequate to encourage further real economic growth at a sustainable pace consistent with containment of inflationary pressures and a movement over time toward reasonable price stability.

In implementing policy throughout the period, the FOMC emphasized the need to evaluate growth in the monetary aggregates in the context of information available on economic activity, prices, and financial market conditions. Among other factors, the strength of the dollar and the related sluggishness of manufacturing activity required attention. As an operational matter, the degree of pressure on reserve positions of depository institutions was relatively unchanged during the period, and the discount rate was reduced once.

Money, Credit, and Monetary Policy

The unusually sharp drop in velocity in 1982 and early 1983, when growth of M1 greatly exceeded that of nominal GNP, had led the FOMC to place

GROWTH OF MONEY AND CREDIT
Percentage changes

| Period | M1 | M2 | M3 | Domestic nonfinancial sector debt |
|---|---|---|---|---|
| Fourth quarter to second quarter 1985 | 10.5 | 8.8 | 7.9 | 12.8e |
| Fourth quarter to June 1985 | 11.6 | 9.3 | 8.2 | 12.7e |
| Fourth quarter to fourth quarter | | | | |
| 1979 | 7.5 | 8.1 | 10.3 | 12.1 |
| 1980 | 7.5 | 9.0 | 9.6 | 9.6 |
| 1981 | 5.1(2.5)[1] | 9.2 | 12.4 | 10.0 |
| 1982 | 8.8 | 9.1 | 10.0 | 9.1 |
| 1983 | 10.4 | 12.2 | 10.0 | 10.8 |
| 1984 | 5.2 | 7.7 | 10.4 | 13.6 |
| Quarterly growth rates | | | | |
| 1984-Q1 | 6.2 | 7.2 | 9.2 | 13.0 |
| Q2 | 6.5 | 7.1 | 10.5 | 13.0 |
| Q3 | 4.5 | 6.8 | 9.5 | 12.6 |
| Q4 | 3.2 | 9.1 | 11.0 | 13.4 |
| 1985-Q1 | 10.6 | 12.0 | 10.7 | 13.4 |
| Q2 | 10.1 | 5.3 | 5.0 | 11.8e |

e--estimated.
1. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

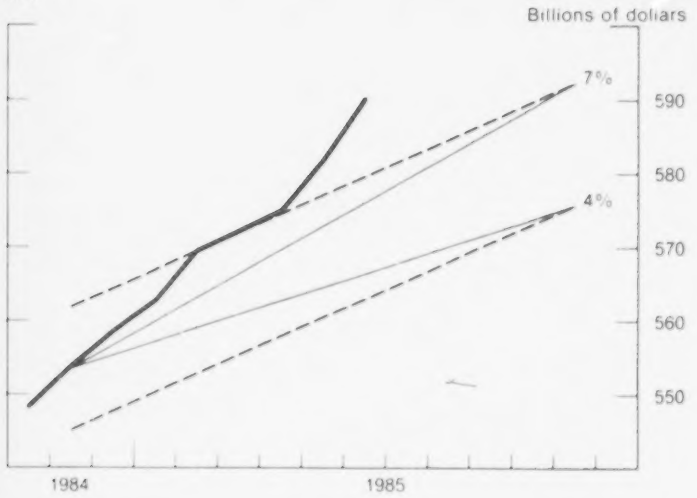
less reliance on M1 as an operational guide to policy. During the latter part of 1983 and in 1984, however, the patterns of M1 growth relative to other economic variables proved more consistent with historical experience, and M1 was given more weight in the conduct of policy. Nonetheless, considerable uncertainty remained, in part because of limited experience with the impact of deposit deregulation and financial market innovations on the behavior of M1 under varying economic and financial circumstances. Similar concerns about possible changes in the account offerings and pricing behavior of depositories and the asset demands of households affect all the monetary aggregates to some extent. These factors accounted in part for the need to interpret movement in the aggregates in the light of other information, including evidence on shifts in velocity.

In the event, monetary policy during the first half of the year had to be adapted to a further slowing in economic growth, as manufacturing activity was essentially flat and the agricultural sector remained under pressure, to a continued high value of the dollar on exchange markets, and to a tendency for the velocity of money, particularly of M1, to fall. Price and wage pressures remained relatively well contained; indications of some acceleration in the early part of the year were followed by more moderate increases in subsequent months.

In that context, monetary policy basically accommodated the strong demands for reserves by depository institutions that emerged during the first half of the year. The total of adjustment plus seasonal borrowing varied within a generally narrow range over the period, though increasing for a time in the spring as a result of special situations affecting non-federally

## Ranges Adopted in February and Actual Money Growth

**M1**

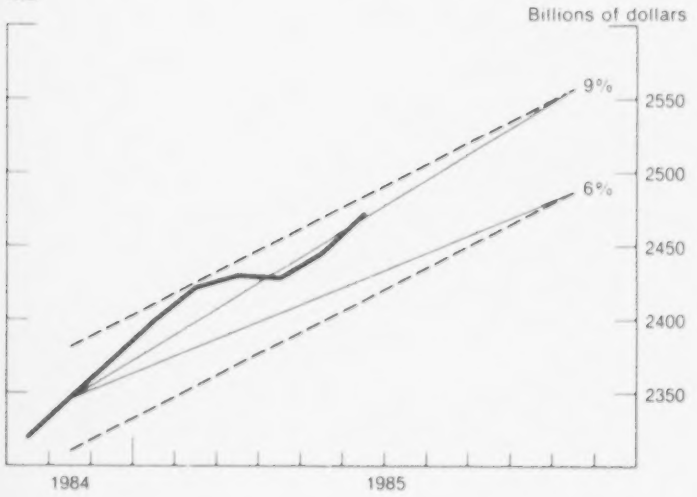



Annual rates of growth

1984 Q4 to 1985 Q2
10.5 percent

1984 Q4 to June 1985
11.6 percent

**M2**



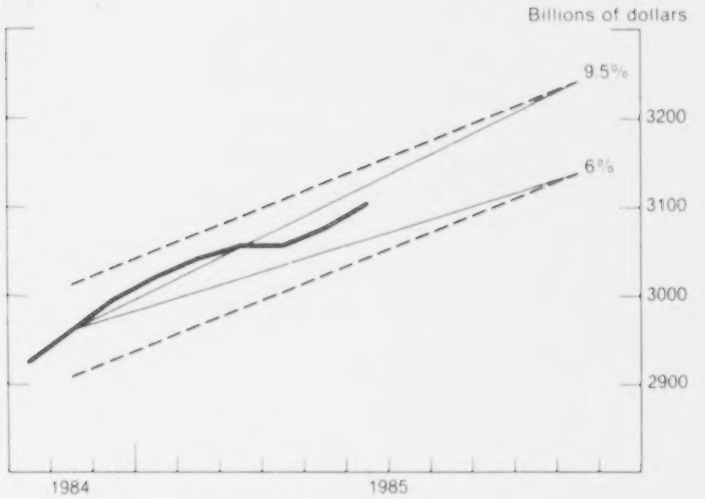

Annual rates of growth

1984 Q4 to 1985 Q2
8.8 percent

1984 Q4 to June 1985
9.3 percent

## Ranges Adopted in February and Actual Money and Debt Growth

**M3**

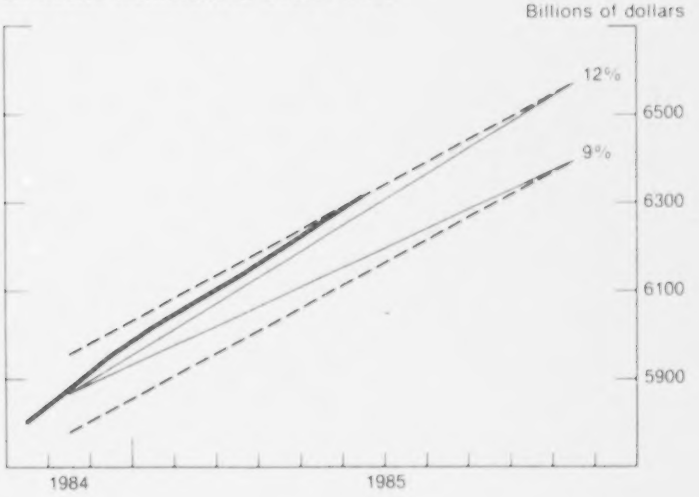



Annual rates of growth

1984 Q4 to 1985 Q2
7.9 percent

1984 Q4 to June 1985
8.2 percent

**Domestic Nonfinancial Sector Debt**




Annual rates of growth

1984 Q4 to 1985 Q2
12.8 percent
(estimated)

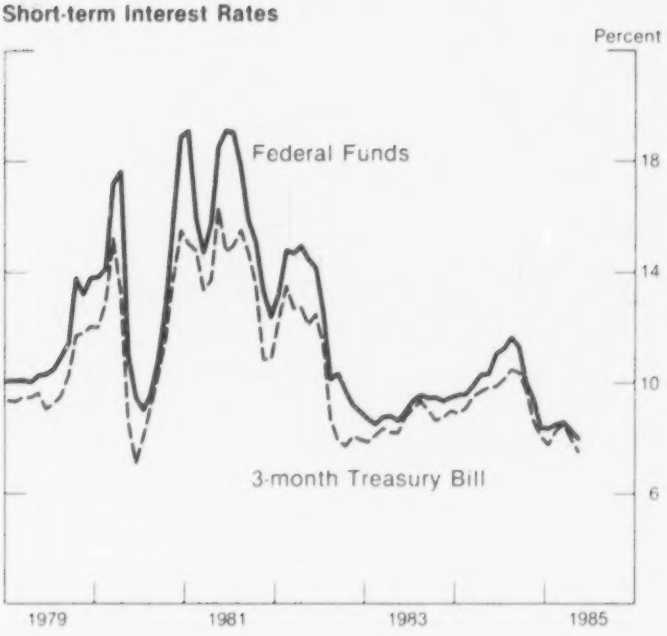
1984 Q4 to June 1985
12.7 percent
(estimated)

insured thrifts in Ohio and Maryland. Reserve positions had been eased considerably in the latter part of 1984 and the early weeks of 1985. With an easing of reserve pressures and a slowing in economic growth, interest rates had declined sharply from their late summer peaks through the very early weeks of this year.

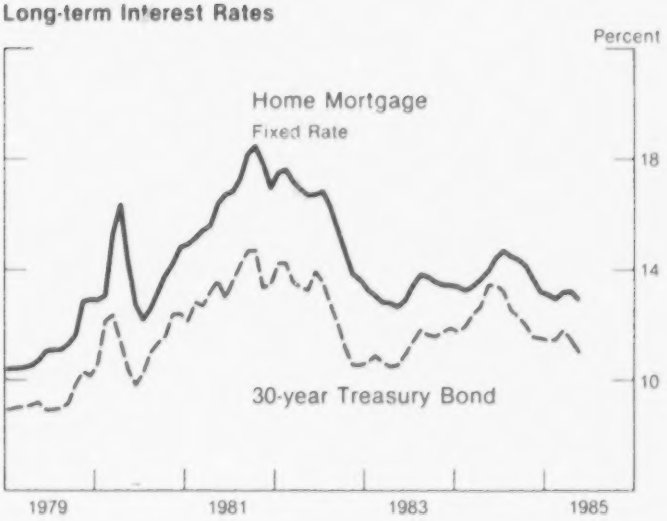
The decline of interest rates appeared to stimulate, with usual lags of some months, a sizable increase in demands for assets contained in M1, principally interest-bearing checking accounts (NOW accounts). Shifts of long-term savings and liquid funds out of market instruments and time deposits into these accounts in the early months of the year entailed a substantial rise in total reserves to support them. As the public's asset preferences shifted toward components of M1, its income velocity declined sharply, because holdings of these assets increased relative to the GNP. Only minimal effects on M1 growth likely resulted from shifts of funds into "Super NOW" accounts after the minimum balance requirement was reduced from $2,500 to $1,000 at the beginning of the year, because the bulk of the funds shifted appeared to come out of regular NOW accounts.

Most market interest rates rose by about a full percentage point from their January lows in the course of the winter, though the level of rates remained well below the 1984 peaks. Demands for credit remained strong. Economic growth had picked up in the fourth quarter and early data for the first quarter, though mixed, seemed generally consistent with moderate growth. While as noted reserve growth was sizable during the quarter to accommodate shifts in the public's asset preference, reserves were provided somewhat more cautiously through open market operations during the period of most rapid acceleration of M1 growth in the first quarter.

**Short-term Interest Rates**




**Long-term Interest Rates**

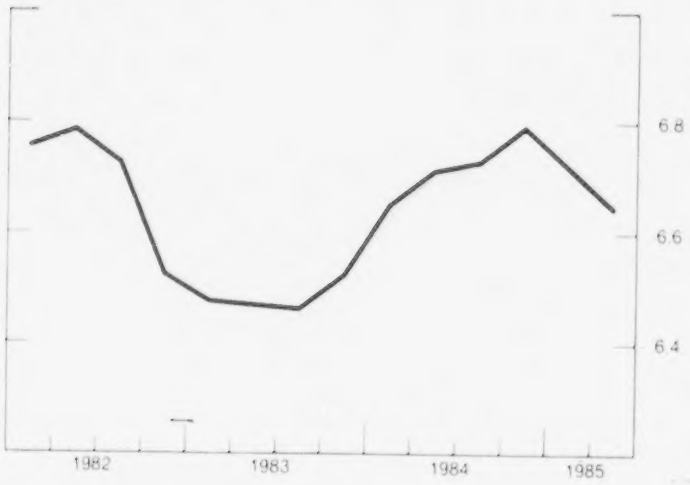


By early spring incoming economic data made it clear that the rate of economic expansion remained limited. Inflation rates continued generally low, prospects for further oil price declines helped damp inflation expectations, and the market responded positively to signs of possible Congressional action to reduce the budget deficit. Growth of M1 moderated substantially, and the aggregate began to decelerate toward its longer-run range in late winter and early spring. Interest rates reversed their earlier rise, as market expectations changed. Rate declines were also influenced by a cut in the Federal Reserve's discount rate in May by 1/2 percentage point to 7-1/2 percent, which took place in the context of continued signs of economic weakness, and against the background of restrained inflationary pressures, and a strong dollar on exchange markets. By midyear short-term rates were down to 3/4 to 1-1/4 percentage point from levels around year-end, while long-term rates had declined by about 1 to 1-1/4 percentage points.

Growth in M1 spurted once again in the late spring. To some extent, interest rate decreases contributed to a strengthening of demand for M1-type assets during the latter part of the second quarter. Growth of NOW accounts, which had moderated in late winter, picked up, as offering rates on Super NOW accounts adjusted sluggishly to the renewed decline in market rates of interest. However, the strength of M1 also reflected an unusual surge in demand deposit expansion in May that extended into June at an even more rapid pace. The rise seems greater than is explainable by usual reactions to the reduced opportunity cost of holding such funds, or to adjustments in compensating balances, and may be partly related to sharp swings in U.S. Treasury balances. A question has been raised as to whether corporate cash

## Velocity of M1 and Treasury Bill Rate

**M1 Velocity**




**3-month Treasury Bill Rate**

(2 quarter moving average)

management practices have become less aggressive in recent months, but there is no clear evidence on the point.

With the sharp late-spring expansion of M1, its velocity in the second quarter again declined, at about the same rate as in the first. The decline in the velocity of M1 over the first half of this year--and the lesser declines in the velocity of M2 and M3--are reminiscent of experience in 1982-83. Indeed, in both the first half of this year and over the one-year period from mid-1982 to mid-1983 the income-velocity of M1 declined at annual rates of about 4-1/2 to 5 percent. The drop in M1 velocity in both periods appears to have reflected, to a considerable degree and with usual lags, declines in market interest rates, although the magnitude of the declines was in both cases somewhat more than could be expected based on past relationships of money, income, and interest rates.

Episodes of velocity decline may be inherent in the disinflationary process. As interest rates adjust downward in reflection of lowering inflation rates, households and firms become increasingly less reluctant to tie up portions of their funds in lower-earning transactions balances. The adjustment has not been steady. Yield declines have been bunched in time, and the ensuing bunched additions to money balances have led to sudden drops in velocity. Unfortunately, the timing of such velocity changes is no easier to predict than is the timing of interest rate changes. Deposit deregulation may have contributed to the extent of velocity adjustments by making the demand for the group of assets in M1 more responsive to interest rate changes than it used to be.

While growth of M1 was quite high relative to its long-run range for 1985, the broader aggregates remained generally within their ranges.

Growth of M2 from the fourth quarter of 1984 to the second quarter of 1985, at an 8-3/4 percent annual rate, was a little below the upper limit of its range, expressed as a cone based in the fourth quarter of 1984. However, expansion of this aggregate in June brought its monthly average a little above the upper end of the range.

Given the deregulation of bank deposit rates, the growth of M2 should be less affected over periods of as long as a half year by interest rate developments because offering yields on most of its components are adjusted in line with market rates and many of the shifts of funds engendered by interest rate changes are among assets within this broader aggregate. But because the adjustments in offering yields tend to lag market changes, M2 does show considerable short-term responsiveness to interest rate changes. Deposit rates, especially on MMDAs, fell much less than market yields last fall, so M2 rose rapidly for several months. Then rising market yields in February and March held back M2. The nontransactions portion of M2 actually declined in April for the first time in 15 years, although this may have been partly the result of difficulties in seasonal adjustment owing to the limited experience with IRA accounts (which are excluded from M2) and with tax payments made out of MMDAs and money market funds. After rates fell back, M2 picked up again strongly in late spring.

M3 growth, meanwhile, was comfortably within its target range during the first half of the year. Issuance of large CDs has slowed substantially from last year at both banks and thrifts. Core deposit flows have accelerated while the rate of loan expansion has held about steady. Further-

more, perhaps in response to new Federal Home Loan Bank Board regulations raising net worth requirements for fast-growing institutions, thrifts have reduced net acquisitions of assets. In doing so, some institutions have taken advantage of declining yields by using the capital gains from asset sales to boost reported earnings.

Growth in total debt remained extremely strong in the past two quarters, averaging a bit above its monitoring range, though below the record pace of 1984. Federal government borrowing continued to absorb more than a fourth of total funds made available to domestic nonfinancial sectors. An increasing proportion of the Treasury's debt carries distant maturity dates; 90 percent of net marketable borrowing this year has been in issues of notes and bonds maturing in 2 to 30 years. Issues of 20- and 30-year debt, in particular, are increasing and now dominate the new issue market for taxable long-term bonds, accounting for over two-thirds of new offerings in that maturity class. This large volume of new long-term debt has changed the makeup of the secondary market as well. The supply of Treasury issues outstanding with 15 or more years remaining to maturity has doubled in little more than 2 years, while the amount of private issues in that maturity range has shown little net change.

Borrowing of state and local governments has been unexpectedly strong so far this year, but an unusually high proportion has been for advance refunding of existing issues, as governments have sought to take advantage of lower interest rates. Because the funds borrowed in such operations are reinvested in financial instruments, they have little net impact on credit market pressures. Indeed, most of these funds are required by law

to be invested in specially-issued Treasury debt, thus reducing the Treasury's need for public offerings. Single-family housing revenue bonds have slowed from the second half of last year. But last year's issues were heavily concentrated in the later part of the year because of delays in the reauthorization of such bonds; recent volume has been close to the 1984 average rate.

Business credit demands have remained strong this year. Slowing growth of both profits and expenditures for fixed capital and inventories has, on balance, had little effect on total borrowing needs. Corporate borrowing has been heavier in the short-term paper and loan categories than in bonds, but not to the same extent as in the early part of 1984, when interest rates were rising. In addition, while new issue bond volume has picked up in response to the lowest long-term yields in five years, maturities of new bond issues have been concentrated in the short- and intermediate-term areas, as they were last year.

An unusual portion of the borrowing, also like last year, has been used to finance equity retirements of one sort or another. Mergers, buyouts, share repurchases, and swaps with shareholders of new debt for stock have continued on the same massive scale as last year. Borrowing initiated with the purpose of financing these transactions may have accounted in gross terms for more than a percentage point of the growth rate of total nonfinancial debt over the first half. But such an estimate may overstate the net effects of recent corporate recapitalizations on debt growth. A number of firms involved in mergers or restructurings this year and last have recently completed large assets sales, some for the explicit purpose of repaying debt. Furthermore, merger activity may be indirectly responsible for some of the

increased new equity offerings because of its generally stimulative effect on stock prices as funds paid to shareholders are reinvested.

Household borrowing also has remained strong. Demand for mortgage loans has been buoyed by declining interest costs. At the lower rates, households have found adjustable-rate loans less attractive than last year, reducing from two-thirds to about a half the proportion of new conventional mortgages with these features. Installment debt continued to rise faster than income in the first half of the year, but the second-quarter data show some deceleration in line with signs of a slowing in the growth of consumption spending on large ticket items.

Other Developments in Financial Markets

Signs of strain in financial markets have persisted this year, but without causing major disruptions in general credit market conditions. Although the government securities market as a whole has been performing well, the failures of three secondary government securities dealers caused losses, sometimes substantial, for some of their customers. A number of local governments and savings and loans were among those hurt, and losses by one large thrift institution in Ohio had further repercussions, threatening to bankrupt the statewide private insurance system and, for a time, generating some concerns here and abroad about the safety of other financial institutions. Runs on privately insured savings and loans in Maryland, some of which also lost money as a result of the failure of securities firms, followed the problems in Ohio. Privately-insured S&Ls in both states were closed or limited to small withdrawals for a time, causing serious inconvenience to some depositors, and some institutions remain closed or restricted.

However, these various problems have been relatively well contained, without significant effects on other institutions and markets. A number of institutions have switched to federal insurance. And the Federal Reserve, acting in its role as lender of last resort, made advances to non-federally insured thrift institutions in Ohio and Maryland to help facilitate adjustments in the face of large deposit outflows. For a while, the borrowing affected the amount of adjustment credit at the discount window but, because of the special conditions, did not add to reserve market pressures as perceived by other institutions. After a time, the borrowings were classified as extended credit.

The thrift industry as a whole continues to suffer from low net worth and mismatched balance sheets, but the recent interest rate declines are improving earnings. The FHLBB has taken a number of steps, including increased capital requirements for rapidly growing institutions to encourage the stabilization of the industry over time. Capital requirements also have been raised for banks, some of which have suffered from a high incidence of nonperforming loans and loan losses in recent quarters. The troubled loans are concentrated in energy, agriculture, and real estate sectors and to borrowers of some foreign countries. Bad news about the loan portfolios of individual institutions and other reported losses have produced some ripples in market rates generally, but spreads between borrowing rates of financial institutions and the Treasury have been quite low for the most part. To some extent, loan losses reflect overly aggressive lending decisions, but the problems of borrowers in the hardest hit industries are partly a result of difficult adjustment to a higher value of the dollar and lower

rates of inflation than were expected when the loans were made. In the agricultural as in other sectors, investors and borrowers have discovered that the inflation of land and commodity prices can no longer be taken for granted.

In light of strains relating to agricultural credit, the Federal Reserve liberalized its regular seasonal borrowing program and initiated a temporary special seasonal program. However, there has been only relatively limited use of seasonal credit owing to the easing of money market conditions as the spring progressed.

With regard to conditions among nonfinancial businesses, the prospects of some of those in the weaker industries--especially those most adversely affected by the high dollar--are subject, of course, to considerable uncertainty. But, in addition, many firms have deliberately chosen a more precarious financial structure in order to enhance current market valuations of shares or to fend off undesired takeover bids. Nevertheless, financial markets have not shown generalized concern about corporate financial structure; notably, spreads between corporate and Treasury debt are unusually narrow, having shrunk since the beginning of the year.

The CHAIRMAN. Thank you, Mr. Chairman. Your entire statement will be printed in the record.

I certainly agree with Senator Proxmire and his comments about irresponsible fiscal policy. It clearly compounds the problem of the Fed in trying to decide what the monetary targets should be. When we started talking about this 4 years ago, I simply did not believe that Congress would ever get to the point where we would continue to allow $200 billion a year deficits.

DIFFICULT TASK OF DECISIONS

It's also interesting to me, as you mentioned, the interpretations of the advance release of your testimony and what you said yesterday. You are correct, the interpretations come out quite differently.

I also remember what Senator Proxmire said to you in your second confirmation hearing when he said:

> You poor devil, it doesn't matter what you do. If you increase the money supply, interest rates will go up. If you decrease the money supply, interest rates will go up. And you will be blamed either way.

So as I watch it, it's interesting. When you're tightening, all the comment out there is that you're tightening too much. If you start to ease, then you're easing too much. So I think you learned a long time ago that it makes no difference what you do, somebody will position themselves on the other side just in case you're wrong. But you are presented with an extraordinarily difficult task in the light of Congress, either inability or unwillingness to do something on the fiscal side of the ledger.

Getting back to your comments about news analysis, this morning's New York Times concludes:

> The Federal Reserve is apparently determined to fight a new public enemy—the trade deficit, by keeping a loose grip on the money reins and fostering low-interest rates.

According to the Times, the Fed has decided to use lower interest rates to push down the value of the dollar and thereby reduce the trade deficit.

But this morning's Wall Street Journal interprets your same testimony differently by saying: "A declining dollar is limiting the ability of the Fed to ease monetary policy."

So who is right? What is the correct interpretation of what you said? Would you tell us what you said?

DOLLAR SITUATION

Mr. VOLCKER. Let me try to clarify the matter. I don't think there is any question that, looking backwards the dollar has been high and rising for a good part of the last year. That has been symptomatic of some of these underlying imbalances that I referred to. That, in itself, of course, is a rather powerful disinflationary force on sectors in the economy that are exposed to international competition. And, under those conditions, that tendency of the dollar to be very strong and rise, was an influence on the judgments that we have had to make on policy and pressures on bank reserve positions over the past year.

I would not interpret that as a desire to push the dollar lower. I think there is a difference between an ingredient in policy of making some decisions at the margin differently when the dollar is strong and rising, and interpreting that as pushing it down.

Of course, in the past week or two the dollar has tended to decline, and you do face a different situation. Speaking for myself, I am not interested in jumping on a downward decline of the dollar and pushing it lower.

The CHAIRMAN. The financial markets have been guessing for the last couple of months whether the Fed would tighten up on the provision of bank reserves to offset the surge in M1 growth that began essentially in May. On page 6 of your statement you indicate the decision was not made to tighten in light of current and likely economic developments, the downward pressures on commodity prices and the high level of the dollar that has prevailed in the foreign exchange markets.

What harm would you have done if the Fed had ended the uncertainty in the financial markets by announcing in May or June that the decision had been made not to tighten up on reserves to slow the growth of M1?

Mr. VOLCKER. I think what we were doing was evident in the financial markets at that time. There was not evidence of a tightening of reserve positions through that period or that the Federal Reserve was pressing to tighten up. The trouble with making an announcement of the kind that you're suggesting is overinterpretation of such an announcement. We are not giving any commitment that a persistence of that kind of development, particularly against a change in the general economic environment, a change with respect to the dollar, would not lead to a change in that posture. And I'm afraid that if you make too many overt announcements it gets overinterpreted in the market as a commitment to maintain a certain position in this technical sense of providing reserves or maintaining or changing reserve pressures.

I think we are better off making our policies evident in the market from week to week in that respect. It's always subject to change in the light of new evidence, which is not the interpretation that is often given when you make a public statement; that is inevitably interpreted by some people anyway as a commitment for a period of time that doesn't exist.

The CHAIRMAN. Well, this is an old discussion you and I have had over when to disclose and what to disclose, but what I hear you telling me this morning is that the uncertainty isn't as bad as over or under interpretation?

Mr. VOLCKER. That is correct. You are always going to have uncertainty. We've had this conversation many times. People want to know where interest rates are going to be next month and next quarter and they would love to know and feel—maybe overinterpret—that what the Federal Reserve does is going to produce that result. That's their job, to speculate and hedge about future interest rates. They are looking for a degree of reassurance in a sense, or a degree of certainty, that we are incapable of giving them.

I don't want to feed what's essentially an illusion that we can promise what conditions in the financial markets are going to be like down the road. That depends upon a whole lot of factors.

The CHAIRMAN. Well, I agree. I guess the only place we would disagree—I say I agree in the sense that you can't make those kind of accurate predictions, but I still feel that the most difficult decisionmaking process out in the business world is dealing with uncertainty and, as you know, I have always fallen on the side of more disclosure. If they want to misinterpret, that is their problem. But it seems to me there is a bigger guessing game going on, more uncertainty, by not letting them know than the risk of over or under interpretation of what you're doing.

Mr. VOLCKER. This is an old discussion that we have had and all I can say is that I have been in this business a long time.

The CHAIRMAN. But how much do we contribute to the gross national product with all those who are paid large sums to try and guess what you're going to do?

Mr. VOLCKER. They're going to sit there anyway, I'm afraid. I don't know of any way to diminish that drag on the real gross national product by diminishing the market for people who are trying to outguess the future. They are going to be there, and I just think in the end there's going to be more confusion rather than less if, in a well intentioned effort to provide more certainty, we end up providing less and also making it more difficult to conduct policy in a flexible way in response to changing circumstances as the unknown future unfolds.

The CHAIRMAN. I suppose you would still agree that the most difficult part of your job is the uncertainty over what we are going to do with the budget. Is that correct? That's the biggest variable of all?

Mr. VOLCKER. I don't know whether it's uncertainty about what you're going to do or the fact that you haven't done anything. We're left with this persistent, big deficit and the imbalances that are associated with it. That's just a hard fact, apart from any uncertainty about what you're going to do. Obviously, if we knew that an aggressive and successful attack was going to be made on the deficit, it would make our decisions much easier.

The CHAIRMAN. And I would assume that your position is still the same, that you would prefer to reduce it with expenditure cuts, but if not possible, you would then go to tax increases?

Mr. VOLCKER. That is correct.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Chairman, I would like to follow up on your line of questioning with Chairman Volcker. In fact, I would go a little farther than Chairman Garn has gone and you've gone.

### FORECASTING OF ECONOMY

It seems to me the forecasting by our economic experts, including the Federal Reserve, has been just about useless for the last 12 years. I can't think of any purpose they have served. Looking back at the record, none of the major economic forecasters called the 1973-75 recession. None of them called the outbreak of double-digit inflation in 1978-79. None of them called the strength of the early recovery from the 1980 recession. They all missed the 1981-82 recession. They all missed the strength of the recovery from that re-

cession or the extent of the slowdown in the first half of this year. Every single one of these changes which are so important for our economy has been missed by the forecasters.

I don't know whether we should pay any attention to them at all.

Now having asked that, let me ask you to make another forecast right now. Could we hit another outbreak of inflation or a deep recession next year and would this be any more unlikely than the real GNP growth of around 3 percent or around 4 percent as forecasters now predict.

Mr. VOLCKER. That either a recession or an inflationary outburst——

Senator PROXMIRE. That's right.

Mr. VOLCKER. I share a lot of your skepticism about economic forecasting and let me just—while you give me the opportunity—just make a modest note in that respect. This so-called flash GNP report is in itself a forecast or a guesstimate that I think we could do without myself; it attracts a lot of attention and by its nature it's not a reliable figure. It just attracts more attention than it's worth.

But in terms of your general strictures, while I share your skepticism about a good deal of forecasting, let me say rightly interpreted—I will give a definition of rightly interpreted—that there is some central tendency, so to speak, some best guess for the future, some range of best guesses. I certainly think the idea of some growth over the next 18 months is a better guess than a great inflationary outburst or a recession. I would not interpret that too literally in terms of the precise figure as to what may develop over the next 18 months because nobody knows that.

But if the question that I understand you posed is, "Is it better to operate to some degree on that premise than a premise of a sharp recession or an inflationary outburst," I would say, yes, we would operate on the premise of growth someplace in the neighborhood of what we projected and what many other people are projecting, keeping a wary eye out for symptoms of change, rather than simply taking a view that we know absolutely nothing about the future.

Senator PROXMIRE. Well, the important thing, then, is to recognize that these forecasts are very, very fallible. They can go either way.

Mr. VOLCKER. I agree.

Senator PROXMIRE. And that there are all kind of ranges like predicting a 70-percent chance of rain.

Mr. VOLCKER. That is precisely the way they are predicted.

The CHAIRMAN. I would suggest though, Senator, after what you said, if they are all wrong, they can be very helpful. Then we just take the opposite view and you and I will be right.

Mr. VOLCKER. I don't know which is the opposite, up or down.

Senator PROXMIRE. Well, your current projections show real economic growth at close to 3 percent for all of 1985 and 1986. Given the fact that there was only 1-percent growth in the first 6 months of 1985, that implies a strong second half of around 5 percent growth followed by a weaker performance in 1986.

What developments are on the horizon that leads you to anticipate fairly strong growth in the second half? Most of your com-

ments about the growing trade deficit, the surge in consumer debt, and so on, would seem to suggest the opposite.

Mr. VOLCKER. When those projections were made I suspect most of the members of the committee making those projections were assuming a somewhat stronger first half than are actually in the GNP figures. They wouldn't necessarily have been expecting 5-percent growth in the second half, but within the range of uncertainty that we are talking about, they were certainly projecting a stronger second half.

When I look at these GNP figures—and I haven't had a chance to analyze them carefully—there is nothing in those figures that suggests to me that growth in the second half couldn't well be more rapid and significantly more rapid in GNP terms than in the first half. I noted earlier that domestic final purchases have been well maintained during this period, not only well maintained but they were at quite a rapid pace in the second quarter. We had a big decline in the rate of inventory accumulation that you wouldn't necessarily think is going to be repeated or continued, and if you maintain final demand and had a change in the inventory picture—in the sense it didn't take a great acquisition of inventories, it just takes no more decline in the rate of growth—that's what changes the GNP, and you could get a significantly higher GNP figure in the second half of the year simply by a change in inventory behavior.

### EFFECTS OF VOLATILE TRADE PICTURE

The other swing factor—and one of the reasons the economic forecasts have been so bad, even the short-term ones recently—is the swings in the trade balance of a magnitude that we simply haven't been used to in the past. Exports and particularly imports are so big now and so volatile from quarter to quarter that they, themselves, swing the GNP figure significantly from quarter to quarter.

We have had an adverse trade picture in terms of change in the second quarter, and if that becomes adverse at a less rapid rate of speed—if you just make that assumption, not that it gets better but that it stops getting worse or stops getting worse at the same rate of speed—the effect of that against maintaining final purchases is to boost the GNP figure. So I don't see anything in this picture that says it's impossible or even unlikely for a somewhat more rapid growth in the GNP in the second half of the year.

Senator PROXMIRE. How about the enormous increase in consumer debt?

Mr. VOLCKER. That is a——

Senator PROXMIRE. That has gone up very sharply. It's close to $2.5 trillion.

Mr. VOLCKER. It is bothersome. The fact that this recovery or expansion has been accompanied by and in some sense, I suppose, dependent upon a big expansion of debt is an unsettling factor. Our big expansion of debt has been partly the Government, but the other area where it's been expanding very rapidly is in consumer credit.

Senator PROXMIRE. Even more than Government.

Mr. VOLCKER. At pure rate of percentage increase, that's correct. We also now have some evidence that delinquencies in that area are rising. They have been quite low, but there is that kind of evidence that consumer debt burdens are now getting clearly on the high side. That could be a drag on growth as well as another source of financial weakness, but I don't think it's reached dangerous levels. Those delinquencies have been low. That has been the most solid part of the credit picture in a sense, but there are some signs consistent with developing strain in that area, too, and so I think that is a potential drag.

Senator PROXMIRE. On page 7 of your testimony you say:

> The potential effects of interest rates and decisions with respect to monetary policy on exchange rates in the external sector of the economy have necessarily been a significant ingredient in Federal Open Market Committee deliberations.

Now that statement seems to lend credence to those who contend that you're easing monetary policy because of your concern that a slowdown in our economy caused by high interest rates due to a tighter monetary policy could deliver a knockout punch to the Third World debtor countries; that is, by shrinking their market for exports here and by increasing the servicing cost of their debt by higher interest rates.

Is that an accurate surmisal of at least one key factor that you or the Federal Open Market Committee must consider when deciding on monetary policy even at the risk of some future inflation here?

Mr. VOLCKER. I think the factors of that sort enter into my thinking certainly. I don't know just how to weigh it. Again, these are all a question of how it affects decisions at the margin. I wouldn't put it just the way you put it, that you take more risks on the inflation side. In one sense, those risks that exist with respect to less developed countries [LDC] debt or growth elsewhere or financial problems domestically are a risk in some sense on the deflationary side.

Senator PROXMIRE. Now as you know, Governor Gramley has left the Board and Governor Partee's term expires next January. Moreover, there have been rumors that another Governor may be resigning soon. This brings up the question of your continued service on the Board.

Can you tell this committee what your current plans are?

Mr. VOLCKER. My status has not changed from the last time we discussed this. I certainly have made no decision on that matter.

Senator PROXMIRE. That means you will stay on how long?

Mr. VOLCKER. We'll see.

Senator PROXMIRE. What was that?

Mr. VOLCKER. We'll see.

Senator RIEGLE. He said through the end of the day.

Mr. VOLCKER. I have no present plans to leave.

Senator PROXMIRE. Well, this is very heartening. At one point when you were confirmed you indicated you probably wouldn't serve out your full 4-year term.

Mr. VOLCKER. I didn't deny that today.

Senator PROXMIRE. What's that?

Mr. VOLCKER. I didn't deny that today.

Senator PROXMIRE. But you didn't confirm it either.

Mr. VOLCKER. I didn't confirm it either.

Senator PROXMIRE. Well, you are certainly a fountain of information.

Mr. VOLCKER. What I said was I didn't feel committed to stay.

Senator PROXMIRE. What's that?

Mr. VOLCKER. What I said was I didn't feel committed to stay.

Senator PROXMIRE. Well, I hope you stay I hope you get reappointed, too. Thank you.

My time is up. I'll be back.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Chairman Volcker, you have never been so brief since I have been in the Senate. Does that mean the economy is great and everything is coming up roses?

Mr. VOLCKER. No, I'm ready to stay here all morning, Senator, that's the first comment I should make. But the economy overall has been doing pretty well, and we have, as I said, a kind of extra burden of carrying the rest of the world to a considerable extent. But everything is not coming up all roses. As I tried to emphasize, there are very, very difficult problems underneath the surface, and not very far underneath the surface. They are quite evident.

Senator HECHT. As I mentioned before in my opening remarks, I applaud your recent stands. Let me ask you a question now.

### REDUCTION OF THE DEFICIT

About 1 year or 1½ years ago, I asked you, to get interest rates down what would we have to do, and you said, "Take $50 billion off the deficit immediately."

About 1 or 1½ years ago, I asked you to get interest rates down what would we have to do, and you said, "Take $50 billion off the deficit immediately."

Now my question is, what will happen if we don't get a compromise and cut the $50 billion off?

Mr. VOLCKER. I think the result will be adverse. I think you are right. I can't quantify it, but during the period when there was growing optimism that the budget cuts would be made that was a reassuring factor in the financial markets generaliy and in the bond markets on interest rates, and it probably was part of the favorable background for the stock market as well.

I think most people are a lot more uncertain about that prospect now, but they retain some hopes. If they really had the feeling that all hope of progress in that direction was shattered, I think it would be disconcerting. It would be particularly disconcerting if something else happened to touch off an adverse reaction in the markets.

Interest rates have been favored, if that's the right word, by a feeling that the economy is moving quite sluggishly at the moment, and that's a very important short-term influence on interest rates. But if you combine lack of progress on the deficit with some other signs that in the minds of the market might point to more pressures on the credit markets—say, either more strength in the business picture that became evident or a declining dollar, or both—

you would have quite a problem, in my judgment, without progress on the budgetary side.

Senator HECHT. Chairman Garn mentioned something while he was speaking and you said a tax increase might be necessary. Let me ask you this question.

If we do not cut $50 billion off and we do not have a tax increase, what will be the result of that?

Mr. VOLCKER. It depends on how much progress you do make, but I think you clearly begin running those risks that I just discussed. The lack of progress or the lack of adequate progress on the budgetary side could well aggravate other forces that would leave us in a very unfortunate circumstance of continuing large imbalances in the economy, less favorable credit market conditions, less favorable financial conditions generally, and much, much more uncertain prospects about the sustainability of the business advance.

Senator HECHT. Thank you.

Mr. Chairman, that's all.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. In view of the expansion of the money supply, are you really more concerned now about a recession rather than renewed inflation?

Mr. VOLCKER. I think we've always got to worry about the inflation thing and I'm not going to prioritize my short-range concerns. There are a lot of things we have to worry about and that I certainly worry about. So long as the sources of those imbalances in the economy exist, I think we take unnecessary risks in both directions.

I just have never thought that the inflation concern is something we can put aside. It is here and it is going to continue to be here. The risks on that side, as I indicated, now primarily arise out of the possibility of a change in the international dimension in the short range. To aggravate that by prolonged excessive growth in money would be very adverse.

### IMPACT OF EXCESSIVE M1 GROWTH

Senator CRANSTON. It wasn't clear to me from what you said earlier exactly what you think the increase of the money supply will do in terms of its impact on the value of the dollar.

Mr. VOLCKER. I would not like that to be an independent influence. As I suggest in my statement, you could carry monetary expansion to the point where concerns about a renewal of inflation from that source interact with a decline of the dollar or precipitate a decline of the dollar that could have very serious implications. We haven't got the luxury or the freedom to permit that to happen, and that is a restraint.

I discuss in some detail and analyze in my statement the increase in M1. I should say in that connection that the increase in the other monetary aggregates, M2 and M3, has been broadly within our intentions. The increase in M1 itself, as Senators Proxmire or Garn noted, while it's been running fairly high all year, was really within the range of our intentions until May and June. The big bulge has been only 2 months. And we know that these figures can be very volatile. We would certainly not like to see that

persist. The whole sense of rebasing M1 with the new target is to indicate our intention that that not persist. If it's a 2-month phenomenon, that's one thing; if it persisted longer, it would raise a whole different set of concerns.

Senator CRANSTON. Do you feel that the present decline in the value of the dollar is going to continue and be adequate to remedy the impact it has on our trade imbalances?

Mr. VOLCKER. I don't think it can constructively remedy our trade imbalance as long as our fiscal posture is in the place that it is.

One of my concerns is that, as things now stand, with the fiscal situation as it is, we can't correct the trade deficit without creating equally serious problems in other areas of the economy, because that trade deficit, by the same token, is a big capital inflow. We are relying upon that capital inflow, in effect, to finance the deficit.

When you talk about correcting the trade deficit, I have to ask you a question—how are we going to finance the budget deficit? We are not going to finance it externally under those conditions, and we're just going to push the pressures onto some other sector of the economy.

So, in a sense, some day we are going to have to correct that trade imbalance. But if you tell me, in a vacuum, it would be nice to correct it next week or next month or next quarter, in a very real sense we almost can't afford to because we are relying upon that capital inflow. I don't know how we would finance the deficit if the trade balance were suddenly corrected.

The only point of that comment is, if you want to correct the trade balance in a context of a growing economy without pushing the pressures elsewhere, you've got to do something on the deficit, because we can't do it by monetary policy. And to try to do it by monetary policy by simply driving the dollar down would have all the inflationary implications that are a matter of legitimate concern.

Senator CRANSTON. Would you comment on Lester Thoreau's thesis that while we do need to do what you advocate on fiscal policy for many reasons, among them to get the dollar down, that the dollar isn't going to really come down unless we intervene in the money markets internationally in order to do so?

Mr. VOLCKER. I think intervention in foreign exchange markets can be a moderately useful tool from time to time, but the importance of that shouldn't be emphasized. I don't think we are going to do this by intervention alone and I don't think it would work if the fundamentals are not more in line with equilibrium.

Senator CRANSTON. Of course, I don't think he was suggesting that it be done alone.

Mr. VOLCKER. I think the contribution that can make is probably rather marginal, and it can be important at times if it is consistent with other policy measures. If it's working against them, it can be destructive.

Senator CRANSTON. One final question on a different matter.

While interest rates of the prime have been down as low as 10 percent, consumer loans with many banks are still up around 18 percent. Why is that?

HIGH CONSUMER INTEREST RATES

Mr. VOLCKER. I don't think they have been--given their problems as they see them—terribly eager to lead the parade downwards in the consumer loan area. Consumer loans are normally more sluggish than other loan rates. They have been coming down in areas like automobile loans where they are more flexible and the competition is quite strong. Where you see very little or no decline, at least until very recently, is in the credit card area where I think there are administrative and other considerations that lead to a lot of stability in those rates and you have seen practically no movement in that area. But you have begun to see some movement in auto loans or straightforward installment credit where transactions are of some size as compared to the consumer credit card area.

Of course, there are substantial fixed costs of something like credit cards, and banks, as well as other credit card providers, are very reluctant to change those rates very frequently.

Senator CRANSTON. Thank you very much.

The CHAIRMAN. Before I turn to Senator Riegle, Senator Dixon has a statement and I would ask unanimous consent that it be placed in the record.

## STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the banking committee conducts its semiannual oversight hearing on the conduct of monetary policy. I always find the presentations of the distinguished Chairman of the Federal Reserve Board to be informative.

The Federal Reserve has already announced it is increasing the target range for M1, the most basic money supply figure. I believe this is a necessary step. Economic growth has been slowing. The gross national product is increasing a too low 2-percent rate so far this year. Unemployment is stagnant at a far too high 7¼ percent. Inflation, however, is likely to remain at 4 percent or below for the year, and it seems unlikely that inflation would be reignited by the modest stimulus this change in monetary policy represents.

Interest rates have declined over the past year, but they are still far too high relative to historical experience. Pressure from Federal budget deficits that will exceed $215 billion this year keeps interest rates well above where they would otherwise be.

It is long past time for Congress to address the fiscal policy issues these figures represent. We must act to substantially reduce Federal deficits and bring Government spending back under control. Monetary policy alone, in the absence of correct fiscal policy decisions, canot ensure stable, long-term economic growth with low unemployment.

I want to take this opportunity, therefore, to say that I think we cannot afford to have the current budget stalemate continued. We need to take the tough actions and to find the difficult and distasteful compromises that are necessary if we are to get the budget savings we so desperately need. Congress and the administration need to work together on a bipartisan basis to reduce the growth of Federal spending. This must be our No. 1 priority. The current low

economic growth rate demonstrates we cannot allow the continuing budget crisis to remain unresolved.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

### OPINIONS ON TRADE DEFICIT ISSUE

Chairman Volcker, as I listened to your response to Senator Cranston on the trade issue, the trade deficit, I must say if I understood you correctly I just think you're wrong. So maybe I didn't hear you correctly or we just have a sharp difference of opinion.

As I understood your answer, you were in effect saying that the benefit of the trade deficit is that it helps ensure that foreign countries will take up our debt, buy our debt instruments, and they are providing a lot of the capital that we are using now to finance our deficit, and I gather that was the thrust of your point in your response.

Mr. VOLCKER. Yes; that's basically the other side of the coin.

Senator RIEGLE. Well, the way my thinking works on this, it seems to me that if we could stop the trade deficit, produce the goods that we are buying abroad internally, generate the wealth in our country, keep the money circulating in our system which presumably would drive up plant utilization rates and would lower unemployment and increase the gross national product, you would have that wealth in-country and you might still have to borrow it for credit purposes, but you would be borrowing it from yourselves rather than borrowing it from foreigners.

I don't understand how we come out ahead by running up an increasing trade deficit and then having to borrow the money that we've just given the foreigners—have to borrow it back from them in order to finance our own overspending. I don't understand the reasoning.

Mr. VOLCKER. Because we don't generate enough savings at home even with a higher GNP to finance that deficit plus all the other things we want to finance. You would get somewhat more total savings out of a higher GNP, but not nearly dollar-for-dollar. It's like $1 for $10 of expansion in GNP. It's less than that; it's maybe $1 for $15 of increased GNP in terms of savings. And that simply is not enough to offset this capital inflow that we're getting from abroad. Suppose just for arithmetic purposes you took that $125 billion current account deficit and added it to our GNP, you're only going to generate out of that maybe 10 billion dollars' worth of savings, but you have to make up $125 billion of loss of capital inflow; and that arithmetic isn't very good. You've lost $115 billion that's going to have to be squeezed from someplace else in the economy.

Senator RIEGLE. I don't think, though, that what you're suggesting is a workable answer and it seems to me that a workable answer is to find a way to drive up the savings rate in this country or lower your debt accumulation.

Mr. VOLCKER. Exactly.

Senator RIEGLE. One or the other. But if you go the route we're on now, what happens is we're sending in effect equity money out of the country. In other words, we are exporting American wealth. We're buying basically consumer goods, consumer durables from

VCR's to cars to whatever from foreign countries. And when these foreign countries, because they have higher savings rates and lend the money back to us, in effect lending what was our money—that was our equity money but now becomes their equity money because we traded the money for some of their goods—they send it back to us and it's a debt transaction. So we go from having an asset on the balance sheet to having a liability on the balance sheet in the sense that we have now borrowed from them so we are not only going to be obligated in the future to pay back the money we borrowed but we now have this debt service cost on top of it.

Mr. VOLCKER. We had no equity money in the United States originally. Otherwise, I agree with that analysis. We are exchanging goods for paper.

Senator RIEGLE. But it seems to me that in the process we are accumulating an increasing debt of a dimension that we've not dealt with in contemporary history.

Mr. VOLCKER. That's correct.

MASSIVE BUILDUP IN DEBT

Senator RIEGLE. And when we add up everything we've talked about today—others have mentioned this massive buildup in consumer debt. The data shows that the consumer debt is running at a rate of 72 percent of personal income and in fact is rising above that level. We've got the massive buildup of internal domestic debt coming off the fiscal deficit which we are all alarmed about. And now we've got this situation where we've just become a debtor nation in terms of our international balance sheet last month, according to the Commerce Secretary, and within 12 months, if we stay on these trend lines, we are going to surpass Mexico and Brazil and become the No. 1 debtor nation in the world because of the severity of this erosion in our financial condition worldwide.

So when I add these things up, this massive pileup of debt, consumer debt, national internal debt, now international debt—I don't know any contemporary parallel to this. We haven't been a debtor nation since 1914, so we've got to go back a long time.

Mr. VOLCKER. There is none.

Senator RIEGLE. It seems to me that what we are doing here is putting ourselves in a highly vulnerable condition financially and to say that the trade deficit in any manner of speaking helps us I think is just wrong thinking. I think what it's doing is it's masking the problem. In a sense, it's buying us some improvement on inflation because presumably we are paying less for the foreign goods, but we are exporting scarce capital which we don't have enough of and we are not saving and reinvesting enough internally, so what we are doing is we are sending the capital out of the country for the foreign goods; they're lending it back to us so we're going deeper in debt for the savings that we are not able to generate by ourselves, and somehow this is seen as a remedy. This is no remedy. We are putting ourselves, I think, in terrible jeopardy.

Mr. VOLCKER. I don't disagree with what you're now saying. We're not sending any capital out of the country, but that's a semantic point.

I accept your interpretation that we're masking the problem and I think you put your finger on it earlier. What we've got to do is either increase the savings or reduce our deficit. I think the prospects of increasing our savings rate significantly are nil over a relevant period of time. Therefore, you're left with one remedy—reduce the deficit.

Senator RIEGLE. Well, maybe we have to do both in a way that we haven't talked about. Maybe we have to take the biggest bite out of the spending side that we can manage to accomplish and get every last dollar of spending savings, and then maybe we're going to have to induce a level of national saving, if you will, by another means that we haven't yet discovered. I mean, one way to do it in a sense, if the savings rate is going to run about 6 percent, give or take, depending on what income levels are, and people tend to keep some savings in reserve, maybe what we're going to have to do is find a way to lower consumption levels, at least for a period of time, by one means or another, to keep that money in an equity form to try to offset this debt buildup.

The thing that I worry about right now, the stock market rocketing up, and partly it's the movement of money between financial instruments. As interest rates have come down there's been a disinvestment in the bond market, a lot of people taking profits on bond holdings and institutional investors, and now the stock market looks more attractive, relatively speaking, and so you get a lot of movement there. Prices go up and I think it tends to create a sense of optimism generally and it's an aura that everything is fine and everything is upbeat and we're making great strides. But at the same time, if you look at this fundamental financial underpinning and our debt structure, it seems to me every trend line in that area is running the wrong way.

Mr. VOLCKER. I don't disagree with that.

Senator RIEGLE. And when I think about the fact that in a year's time we're going to be the leading debtor nation in the world, what do we make of this? This is something that hasn't even become yet a part of the national debate as yet, but how are people to make any meaning out of what the implication is of that fact?

### NEED TO INCREASE SAVINGS RATE

Mr. VOLCKER. The meaning they ought to give it, it seems to me, is that we have a gross disequilibrium that indicates that something is wrong. What it indicates is that we are borrowing more than we are saving. You can talk about increasing the savings rate. I just note that the savings rate in the first quarter of this year was 4.5 percent, and in the second quarter it's estimated at 5.3 percent. If we could get that up, it would be wonderful. But I think you're operating under an illusion if you think that that's simple or that people know how to do it. The savings rate has been in a channel of 4 to 7 percent or so for 20 or 30 years, and I don't know of any way, with any assurance at all, that you can introduce any heroic measure that is going to magically produce a change in a trend that's persisted for so long. I don't think you ought to count on that at all.

Obviously, it's even better if you can work on the side of reducing the demand for debt and that clearly is within your power.

Senator RIEGLE. And that we should do. It seems to me that taxes—an issue that nobody wants to talk about—but it's something that must be looked into. If the Nation finds itself overspending, either in terms of its national spending efforts through a Federal Government system or overspending in terms of the sum total of what all the individuals are spending, another way to cut down on the consumption is to tax off some of that money and not spend it, use it to reduce maybe past debts or other obligations and so, in a sense, you create a national savings rate increment above whatever that residual 4 to 6 percent is by individuals.

But it seems to me we could even do some jawboning here. We are a Nation that is conditioned on consumption and spending—we could go through any paper today and find that we are encouraging people to take on more debt. I've just been looking through the papers here today. There are sales going on on credit all over the country by all kinds of financial institutions and, frankly, as you increase the M1 targets and make money more available, that helps cause that to happen. Maybe we need to have more conversation from yourselves and from the Fed and from the President and other important national leaders that maybe it's time for people to save a little more and consume a little less. I mean, can we say that or does that jeopardize the economy right now because of how fragile things are?

Mr. VOLCKER. We can say it, but I have no faith in that as an important policy tool in producing a significant change in the savings rate or in the dilemmas that we face. And I think we would be kidding ourselves if we think we are going to deal with these imbalances by jawboning.

Senator RIEGLE. But I'll just finish with this—if it's your belief that the savings rate is dangerously low, given our overall pressures, and it needs to go up—we need to find a way to drive it up—it seems to me then it becomes an obligation to talk about that problem and how we make that happen, and not to act in the reverse way and that is to sort of give the signal that everything is fine and dandy and people ought to continue to increase their debts. Obviously, the Federal debt needs to be reduced notwithstanding, but the general tone and the thrust today is that we can continue on this spending binge as long as we want without any great consequence, and it seems to me that as I look at it, we are right out to the very outer edges of our financial capacity to absorb new debt at all these different levels and, in fact, they all combine. You can't really in the end separate consumer debt from national debt from international debt. If they are all negative and growing and you add them up, it seems to me you have to say it's time to sober up.

Mr. VOLCKER. I don't disagree with that, but I think the way to attack the excessive increase of debt, and the place where it should be attacked, first of all, it seems to me, is the Federal deficit. If the message that comes out from the kind of approach you're suggesting is that we can deal with that by increasing the personal savings rate, I think we would be doing a disservice.

Senator RIEGLE. Well, I'm also saying do something about the trade deficit. You sound awfully passive on that issue and it seems to me that when you're running a deficit of $150 billion a year and it's rising and you've just become a debtor nation, you'd better pay attention to the trade deficit.

Mr. VOLCKER. I think we ought to pay attention to the trade deficit. All I am saying is that in the condition in which we now find ourselves, getting rid of the trade deficit is no freebie.

Senator RIEGLE. Well, my time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Chairman Volcker, two of the Senators who are sitting in front of you today are members of the conference committee on the budget and I would like to ask you for a little bit of your advice with respect to that process.

BUDGET REDUCTION OF $40 BILLION

You began this year and have consistently held to the position that it was important that we reduce the budget deficit for 1986 by some $50 billion or more. Nominally at least, budget resolutions passed both by the Senate and by the House reached that goal. Perhaps you will assume for the purposes of this question the validity of the accompanying analysis. We sometimes engage in a little bit of false advertising. Probably the Senate version was closer to somewhere between $50 and $52 billion than $56 billion in real numbers. The House version is about $12 billion less than that, say $40 billion in real numbers when you take out things like transferring money from one pocket to another in connection with offshore ocean revenue.

Several of us on that conference committee made a more broad-based proposal which included revenues to the extent of $1 for every $5 of spending cuts but had far more in the way of spending cuts than did any of the other proposals that roughly on the same analysis probably had $70 billion in deficit results for the first year. That's been rejected and it's unlikely to be revised at this point.

My question is a two-part one. Is something better than nothing even though that something is only $40 billion; and how much difference is there between doing a minimal job which must be approached again next year or doing something more decisive and something which even objective analysis might say would lead us to a balanced budget within the foreseeable future? What is your advice and counsel to us as far as our short- and long-range future with respect to this conference committee is concerned?

Mr. VOLCKER. I think you're getting into an area where I just can't make a judgment. I don't know what the negotiating situation is. I am certainly not fully qualified to judge the reality of some of these figures as opposed to the cosmetics of some of these figures.

But, in concept, obviously, something is better than nothing. And what you can get in practice, in some sense, is what we have to settle for.

I would hate to see getting something for the sake of getting something, at the expense of giving up a more adequate program.

But that's not a judgment that I can make, whether you have that realistic choice before you.

The more, the better, within reason. And as I said before, there is no danger that you are going to get too much. I would certainly feel the more you could get, the better. But in the end, something is better than nothing, quite obviously.

I think there is inevitably—it can't be completely identified—some kind of psychological threshold in terms of market response, and if you go under $50 billion—which, I think, has become kind of a symbol—I don't see any way you're going to get any positive psychological impetus from it. You will avoid some disappointment.

I don't know whether that adequately answers the question or not.

Senator GORTON. It certainly gives some direction but let me push you a little further. If we were able during the course of this year to come up with a program which would realistically be believed outside the debate in Congress to promise something close to a balanced budget within 3 or 4 years, how positive an impact on the economy would that be likely to create?

Mr. VOLCKER. If you could realistically come up with a program that approached a balanced budget—I'm not sure that that's within your grasp, but if you could——

Senator GORTON. I said within 3 or 4 years.

Mr. VOLCKER. I understand. That would have I think a very positive impact on sentiment in the financial markets. A lot would depend upon the credibility of that. But I don't think there's any doubt that that would have a positive impact on financial market sentiment and it would set up a backdrop, so to speak, where you could realistically look toward an elimination of the trade deficit or a very sharp decline in the trade deficit without posing the kind of threat that I was discussing with Senator Riegle. That is one of the important aspects of that. It would put us in a position to absorb a reversal of that trade deficit with minimal inflationary and other impacts.

Senator GORTON. That certainly bridges to the next subject on which I would like to have your advice on.

You have talked about that bridge and about the fact that the trade deficit helped us cover these horrendous budget deficits in one sense at least, and that the strong dollar has helped reduce inflationary expectations. Now obviously, we have something of that story in the Washington Post this morning. We have a dollar which has begun at last to weaken which, from the point of view of many, seems very important with respect to at least the reduction in the trade deficit.

If the dollar continues to weaken, say as much in the next 3 months or so as it has in the last 3 months, is it likely to increase inflationary expectations? Is it likely to be enough to put the trade deficit on a decline? And how do we judge the value of those two courses of action or those two possible results against one another?

Mr. VOLCKER. Let me say flatly I would be concerned about that if it came against a background of lack of progress on the budget deficit. I think the reasons that the dollar might decline, and the effect it would have on the trade balance, would vary and are very important. If the dollar tended to decline some from levels that are

still historically high because there was a genuine relief in pressure currently or prospectively on our financial markets and a growing conviction that inflation will in fact remain under control, it could have some constructive effects. If you have that same kind of decline because people fear inflation and wonder about the future of the American economy and the deficit, the flip side of the coin looms very prominent in my mind.

I think a great deal depends upon the environment in which that happens, if it does happen. I don't think we are in any position to look upon appreciable declines in the dollar, particularly after the declines that we have had, as a good thing if we haven't gotten our domestic house in order.

Senator GORTON. Thank you, Chairman Volcker. That's a very clear explanation.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Volcker, let me pursue just a moment the line of questioning that Senator Gorton was pursuing

DEFICIT REDUCTION TARGETS UNATTAINABLE

I think clearly now we are not going to reach the deficit reduction targets that you were widely quoted in the press as recommending somewhere in the neighborhood of $50 to $55 billion. There was some controversy at the outset between the Senate Budget Committee and others as to whether even the Senate budget that was passed here met these targets because we were using OMB numbers to arrive at our $56 billion deficit reduction package, which David Stockman has even backed away from now, as you know. And using the more realistic CBO numbers, I think our deficit reduction package here in the Senate was coming in somewhere in the neighborhood of $38 to $42 billion.

Well, it now appears that no matter whose numbers you use that's going to be unattainable. The President has indicated that he is not going to stand for any revenue increases and the Speaker of the House, responding to his Members whom I assume are responding to public opinion— they all run for office over there every 2 years so I expect they know what their constituents want perhaps even better than we do here in the Senate—they are saying that there's not going to be any cut in the Social Security totals, so there will be no significant reduction in entitlements.

Well, given that, we are not going to meet the targets that you laid out early, or have been quoted in the press as having laid out.

Now what happens if we do come in here with a deficit reduction package for this fiscal year that reduces the deficit somewhere in the neighborhood perhaps of $42 billion, using OMB numbers, and $30 billion, using CBO numbers? Hasn't that already been discounted—that possibility or even probability—hasn't it already been discounted by the financial markets? I see the stock market continuing to go up. I didn't observe it yesterday, but it's been reaching all-time highs in recent days.

I suppose my question to you is, what happens if we do come in with these lower deficit reduction targets—lower by about 20 or 25

percent? Can we say that the financial markets have already discounted that probability?

Mr. VOLCKER. That's a difficult question for me to answer.

Senator SASSER. It's a difficult question. That's the reason I asked you, Mr. Chairman.

Mr. VOLCKER. I don't think the financial markets ever were fully convinced that you were going to do the $50 billion plus in realistic terms. I don't know what the effects would be. You're within an area that may reflect the assumptions in the marketplace right now.

But whatever the case may be with respect to those expectations, I think you are certainly leaving the economy more vulnerable than it would otherwise be.

Senator SASSER. Well, how extensive is that vulnerability?

Mr. VOLCKER. Very.

Senator SASSER. Very vulnerable in your judgment?

Mr. VOLCKER. Yes.

Senator SASSER. Well, I must say that I concur in that judgment, but I wonder why all these people who put their money on the line in Wall Street don't appear to concur with the judgment that you and I have on this matter. That's the mystery to me.

Mr. VOLCKER. I think politically you're dealing with a situation where the economy is advancing. It's had a rapid advance. Inflation is down and people can say, "Where's the problem?" And I think, as perhaps Senator Riegle was suggesting earlier, the underlying problems have been masked in some sense by the trade deficit and the accompanying capital inflow. But it gives a lot of pain to sectors of the economy that are affected by the trade balance, which is practically the whole goods-producing side of the economy.

How and why is Wall Street reacting the way it is? They have seen the slowdown in the economy and the GNP. That, in itself, has been a factor bringing interest rates down in the short run. I will leave explanations of the stock market to you.

Senator SASSER. Well, I gave up on the stock market long ago, Mr. Chairman. I have never made a dollar on the stock market and don't anticipate that I ever will. I have just given up understanding that.

### SIGNIFICANCE OF DROP IN OIL PRICES

Let me move on to another topic. There's a lot of conversation now that we may see a rather significant reduction in world oil prices. Some economists worry that a further drop in oil prices may mean a resurgence of the threat to world economic stability. I direct your attention particularly to some of our countries south of the border. Mexico, for example, loses $545 million a year in export revenue for every $1 decline in oil prices and Venezuela loses close to $600 million for every $1 or decline. If oil prices do in fact drop—let's say they drop $5 a barrel, which some say is well within the realm of possibility, what happens to the oil exporting Latin American debtor nations? Are they threatened then with economic collapse? What does this do to our banks and our financial structure in this country if that starts?

Mr. VOLCKER. I think "collapse" is too strong a word, but it would obviously increase the external financing needs of Mexico. If you got that sharp a decline in the oil price, on a worldwide basis it would have an effect of reducing the general price level and I think, all things equal, you would expect that that would be a force toward lower interest rates. Mexico benefits very substantially; so does Venezuela, but less so.

Senator SASSER. Is it a wash?

Mr. VOLCKER. It depends upon what the relative numbers are. A decline of 1 percent in interest rates is of more benefit than the hurt of a $1 decline in the oil price. But you've got to fill in the numbers that are relevant on both sides. So far, in some sense, if you take as a base point interest rates last summer and look at the decline in interest rates and look at the decline in oil prices since last summer—just looking at those two factors—Mexico is a net beneficiary. They are better off from those two changes. But if you changed the relative proportions, obviously—of the decline in the interest rate and the oil price—you get a different answer. The idea of having a 5-percent decline in interest rates, carrying short-term interest rates of a Treasury bill rate down to 2 percent, I don't think is on the likely horizon, so you would not get a wash if oil prices declined by $5, but there tends to be an offset in direction anyway.

I think a lot would depend, in the case of Mexico, on whether the price decline was $1 or $2, or whether it was $5, assuming there's a further decline at all. They have reduced their oil prices, as you know, in the last couple weeks.

Senator SASSER. There have been significant improvements, I read, in the debt situation for the big four Latin American debtors—Mexico, Venezuela, Brazil, Argentina. But there have been a number of defaults among smaller debtors such as Bolivia and Peru.

A report by the Overseas Development Council indicated that our American bankers are virtually ignoring the problem among the smaller debtors since they are perceived in any case to pose less of a threat to the financial institutions and to the financial system overall.

Mr. Chairman, do you see these defaults taking place among the smaller debtors as being something serious that we should be concerned about, and do they portend further problems for the big four, either economically or politically, in your judgment?

### ARREARAGES OF SMALLER DEBTERS

Mr. VOLCKER. Well, I think they are a matter of concern. You say defaults. That's a relative word, I suppose, these days. They have arrears in differing amounts. But there is the danger of contagion in this process and I think to the extent possible we need to work—the banks, or governments, or the IMF, or the World Bank—with all these creditors to see whether we can arrive at a reasonable solution. That's more difficult in some cases, and there are differing degrees of willingness on the part of those borrowers in each individual case.

In the end, if you have a situation with some smaller country where there is not a willingness on the part of that country to do what seems necessary or their problem is intrinsically too difficult, I don't think that needs to create a major crisis for the whole world, but I think there is always a danger of some contagion. I don't think the situation even with the four major borrowers is uniform and as comforting as you may have suggested in all cases. They have their ups and downs too, although I think by and large there's been progress.

Senator SASSER. My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

You have covered a lot of ground this morning, Mr. Chairman. Just a couple of points, if I could.

EFFECTS OF SLOW GNP GROWTH

One, the Fed has estimated GNP growth to be somewhere between 2.75 and 3 percent between I think it is the fourth quarter of 1984 to the fourth quarter of 1985—that's about 1 percent less than estimates of a year or so ago, if my memory serves me well.

What is that going to do in terms of projected increases in budget deficits, assuming that my colleagues here are correct in their pessimism and that they are unlikely to get a budget resolution? We have a member of that distinguished committee sitting with us. But assume for a second we don't get one.

Senator GORTON. There's one sitting right beside you, too.

Senator DODD. What do we get as a number coming out of that?

Mr. VOLCKER. Maybe I can give you an estimate. It doesn't have a lot of effect in the first year. If it were continued into another full fiscal year, I guess the estimate would run for 1 percentage point lower real growth—I don't think our estimate has been reduced by quite that much. You get in the $15 to $20 billion area when it's had time to have a full year's effect.

Senator DODD. Everyone else has been commenting in the last several weeks about the various tax proposals—the Administration's tax proposals. I can't resist asking you, since you're here this morning and I may not get a chance to see you again—if you care to comment on the President's Treasury II proposal.

How important, first of all, is that issue as opposed to the question of budget deficits? For a while it elbowed out, it seemed to me, the budget deficit question. I think that's come back a little bit, but at least for a short period of time it seems to have crowded out that question from the concern of the administration and many here on the Hill. So the first question is, in relative importance where would you put it; and second, what do you think of it?

Mr. VOLCKER. In terms of its relative importance, the first comment I would make is that they are both very important subjects and while they overlap at some points they are basically directed against different problems. I think the question of tax reform and a proper tax system is obviously terribly important intrinsically.

If you were looking at it from the standpoint of the impact on the economy and the development of the economy over the coming years, I think the deficit question is more important and more

urgent. But that is not in any way to say that tax reform is not, in itself, for other reasons, a terribly important subject and I would hope you could manage both.

Senator DODD. Did your staff or anyone take a look at the proposal and, if so, did you draw any conclusions about its impact on the deficit?

Mr. VOLCKER. Our staff has looked at the proposal, but I'm not sure we're the leading experts in this area. There are a couple of questions which I'm sure you're familiar with as to when you get beyond some transition period what the net effect might be over time on the deficit, and a lot depends on what assumptions you make about inflation. I would like to make an assumption near zero, but that's not what other people want to make when they get out to 1995 or whenever the transition is over. You get different answers depending on what assumption you make. Most of the assumptions produce revenue loss, but that's out quite a period into the future.

I think the question that arises in the shorter run—to which I don't know the answer—is whether some estimates of revenue loss are harder than some of the estimates of revenue gain from closing loopholes. I think that's an inherent difficulty in this kind of estimate.

Senator DODD. But it would be totally inaccurate to call the tax proposal Treasury II as revenue neutral? That's for sure, isn't it?

Mr. VOLCKER. I don't know. For this transition period which is rather long, I think it depends upon a judgment that you make as to the relative hardness of the estimates for the savings as opposed to the losses. And while I know that question has arisen, I don't have a strong judgment about it. I have not looked at it in that degree of detail.

Senator DODD. And your staff hasn't drawn any clear conclusions on it?

Mr. VOLCKER. I think they have raised that question but I don't think the conclusions are that clear.

Senator DODD. Has the Treasury asked the Fed to comment on this proposal at all?

Mr. VOLCKER. Not really. I made some informal comments in the course of very informal discussions but we were never asked per se to comment on it, and I don't think I'm competent to comment on the great bulk of the program. I am interested, obviously, in some aspects of it. I don't like the idea of indexing things, let me just say that flatly. That's not a new term and this proposal increases the tendency to index things. I just don't like that tendency to think you can cure problems by indexing, for a variety of reasons. You cure the inflation problem by getting rid of inflation, in my judgment.

### TAX REFORM PROPOSAL

It's a very difficult issue, but one of the areas of tax reform that is relevant to the performance of the total economy, I think, is this inbred bias we have in the present tax system against equity financing and in favor of debt financing. In any tax reform proposal, the more progress that can be made toward correcting that—and

there are some things in this proposal that make a little progress in that direction—the better off we are.

Senator DODD. But isn't a good portion of it oriented toward increasing consumption?

Mr. VOLCKER. You can raise that question, too. I am not sure the answer to that is fully clear even in the long run. You're getting out of an area that I've looked at closely. I think a lot depends—in terms of the effective tax rate on business—on what kind of inflation assumptions you make, because of the indexing provisions.

Senator DODD. Just one other question quickly. It may have been asked by the chairman. The chairman of our committee is going through the difficult time of trying to decide what we ought to do with the bill we passed last year here dealing with financial institutions 'expanded powers.

I wonder if you might just quickly give us an assessment of what would be the repercussions or what would happen if we don't do anything in the Congress in that area, what happens—is there as much of a need today, given the recent court decisions in some of these areas, for us to move in this Congress? Just give us any comments you may have on that.

ASSESSMENT OF FINANCIAL SYSTEM DEVELOPMENTS

Mr. VOLCKER. Let me give you one example of the kind of mess that we're in and the kind of, at the very least, risk you take of this thing getting out of the hands that it should be in, which I think are yours. What kind of direction do you want the financial system to go in as opposed to almost random developments in the marketplace?

We have a case in the Supreme Court now where one of our decisions, giving a reasonably broad interpretation of our power to define a demand deposit and a commercial loan in connection with this nonbank bank issue, was overturned in the district court and in the appeals court. It's now in the Supreme Court. The courts said we took an overly expansive definition.

In the meanwhile, we have a decision in another appeals court saying we take an overly narrow definition or position with respect to our powers and we must rule out nonbank banks; that nonbank banks are really banks and the Bank Holding Company Act says they must be ruled out of order.

I don't know what way the Supreme Court is going to decide, but they are going to decide the issue. You're not going to decide the issue. And that doesn't seem to me to be appropriate. One said we are too expansive and the other said we are too narrow. I don't know what kind of court decision we are going to get, but if they supported the position that we are overly expansive you've got an open door again to nonbank banks. If they decide the other way, you've got a completely closed off door, I suppose, so far as national banks are concerned; I'm not sure you've got it closed off for State banks. Again, it's Congress who ought to be telling us what public policy is in this area; we ought not to be getting decisions that are based on some particular interpretation of law written in a different context that are completely arbitrary and often conflicting, as

we have now—two specific, conflicting decisions in the appeals court. That's one area.

One area that I am, frankly, very concerned about—and I think Congress has to tell us our position—concerns both the savings and loans as well as banks. There has been a kind of competition among States to provide very expansive powers that raise real questions about the safety and soundness of the financial system, in my judgment. I think that some limits ought to be put around the ability of States under the cover of Federal insurance, to provide powers to institutions that seem to me basically incompatible with the safety and soundness of the system, and at the very least put risks on the insurance system that weren't contemplated by the Federal Government in creating the insurance system in the first place.

We have certain powers and we are discussing that issue so far as bank holding companies are concerned, but at the very least it's clear that existing law does not leave us or the other regulators—and the Home Loan Bank Board feels very strongly about this—with clear cut powers to deal with this situation straightforwardly.

Senator DODD. My time is up. I agree with you wholeheartedly on that. You don't see any direct threat to the dual banking system as a result of that, do you?

Mr. VOLCKER. I think the dual banking system rests upon a kind of comity between the State and Federal authorities and, as I view it, the State authorities are violating that sense of comity. They can experiment and should experiment and have a certain discretion without undercutting the Federal interest in a safe and sound banking system, which the Federal Government protects. I am kind of bemused, I suppose, by some of the comments about the dual banking system, particularly from the banking community. When it comes to a question of usury statutes, they are very vigorous in saying that's a national interest that ought to override the States, but when it comes to the States doing something they want to do, it suddenly becomes a matter of States rights.

Senator DODD. Well, I couldn't agree more with you on that and I appreciate your digressing as well from the major thrust of this hearing, Mr. Chairman, but I didn't want to miss the opportunity of having the chairman hear his comments.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman Volcker, I want to get back to the future of the Federal Reserve Board. Has the White House given any indication to you that you will be consulted on filling vacancies on the Board?

Mr. VOLCKER. No, not one way or another. I haven't discussed it with them.

Senator PROXMIRE. Do you think it's appropriate and desirable that you be consulted?

Mr. VOLCKER. Yes, sir.

Senator PROXMIRE. Well, I'm glad to hear you say that. I think it's very important that you be consulted.

FOMC DEBATES MONETARY POLICY

Mr. Chairman, the minutes of the Federal Open Market Committee [FOMC] meeting of last March 26 indicate a strong debate on the future course of monetary policy. While a majority of——

Mr. VOLCKER. The minutes of when?

Senator PROXMIRE. Of last March 26. While a majority of the Committee was concerned about an economic slowdown and was willing to tolerate more rapid monetary growth, some members believed that the money supply was growing too fast and would have supported greater restraint.

Now that we have 3 more months of experience, how substantial is this "let us show restraint" element on the Open Market Committee, and are they still advocating restraint or have they moved over to the majority viewpoint that a more rapid growth in M1 can be safely tolerated?

Mr. VOLCKER. I don't remember anything special about the March discussion, but these various points of view are usually debated. It's absolutely typical of a meeting that varying degrees of concern are reflected about these different crosscurrents, whether in the monetary figures or otherwise. I think there are bound to be differences in view in terms of emphasis within the Committee on weighing the growth in the money supply against other factors; that, in a qualitative sense, continues.

I think it's also true that the decisions that we have been able to arrive at have not necessarily been unanimous but they have commanded a large degree of concurrence.

Senator PROXMIRE. My question is, is there more of a consensus now in view of the fact that the economy is more clearly slowed down and unemployment has not improved for 5 consecutive months and is at a very high level on a historical comparison? Is there more of a consensus now that the economy has——

Mr. VOLCKER. I'm not sure, because what you say is true and in one sense has probably strengthened that view in some people's minds. On the other hand, we did have this surge in the money supply in May and June which we had not had in March and that's obviously a point of concern.

I have no clear memory of it, which reinforces my feeling that the discussion in the March meeting was not exceptional in terms of presentation of different views or the vigor with which they were argued. These differences are quite natural and they are characteristic in some degree, of every meeting.

Senator PROXMIRE. Let me ask you, what caused the unforeseen economic slowdown? Last February, when you appeared before this committee, your report indicated the Federal Reserve was projecting real economic growth of close to 4 percent in 1985. Instead, the rate of growth for the first half of this year was only 1 percent. As you look back with the benefit of hindsight, where did you go wrong last February and what assumptions did you make that proved to be too optimistic and what developments did you fail to anticipate?

Mr. VOLCKER. I can only answer implicitly, because those projections are an average of the members of the committee, and I didn't review their forecasts to see what went wrong. But I suspect the

overall answer is evident. They probably were not assuming, as a whole as sharp a reduction in the rate of inventory accumulation during this period as we in fact had, and it may be that many of them were not assuming this further deterioration of the trade balance to the extent we have had it. I suspect it is those two factors.

I would be very doubtful that it was slower growth in gross domestic demand, which has been very well sustained. If anything, I would guess that is higher than people were projecting. And I would say in that connection—you're talking about a two-quarter period—just in reference to your own earlier comments, that a deviation of presently estimated GNP growth for two quarters in the neighborhood of 1 or 2 percent at an annual rate is not unusual and I might say should be anticipated. Nobody's forecasts are that accurate even for that short a period of time.

I think it's at least as important to look at the composition of what's going on, and as I look at these figures——

Senator PROXMIRE. This is a colossal mistake. Here it is a 1 percent growth, not a 4 percent. It was one-quarter of the growth that you anticipated.

Mr. VOLCKER. You say a colossal——

Senator PROXMIRE. This is a colossal mistake. Here it is a 1-per-

Mr. VOLCKER. It didn't take much of a drop to get it less than you're anticipating. They were probably anticipating slower growth during the first half of the year. Say they were anticipating 3 percent, which is just a little below what they were anticipating for the year in the first half of the year. It comes out to an average of a little over 1 percent. If you looked at the flash figure of the Department of Commerce only 1 month ago, which was 3.1, just the difference between a flash figure and another estimate for one quarter was more than 1½ percent.

Senator PROXMIRE. Well, I don't want to press you too much on that, but the fact is that a 3-percent growth is a good—a predictable growth. We have had that over the years by and large on the average. One percent is stagnation. One percent just doesn't do the job. You know that.

Mr. VOLCKER. I know that, as prolonged over time. But nobody is going to predict in a two-quarter period what the rate of inventory accumulation is.

### EFFECTS OF HOSTILE TAKEOVERS

Senator PROXMIRE. Let me ask you about another subject. When this committee held hearings on hostile takeovers, we were told by OMB that hostile takeovers involving a substantial debt restructuring were generally good for the economy. OMB argued that many corporate managers who were sitting on a low debt-equity ratio were not doing a good job for their stockholders, they could get a greater return on equity by higher leveraging, and if they were unwilling to restructure their balance sheet corporate raiders were ready, willing and able to do so for them.

What's your view of the economic effect of higher debt leveraging? Is it an unmixed blessing, as OMB suggests, or are there some downside risks to the economy resulting from the higher debt structure?

Mr. VOLCKER. Obviously, it increases risk, speaking as a generality.

Senator PROXMIRE. And by and large, we've had a big increase in corporate debt, a diminution in equity, because of corporate takeovers over the past 2 years. Isn't that correct?

Mr. VOLCKER. Yes. I think that looked at overall that increases the financial risks in the economy. Now I can't say, quite obviously, about any particular firm. It increases the risks for any individual firm, too, but it may be that they are still reasonably conservatively financed. That's a question of the facts of a particular circumstance.

Senator PROXMIRE. But overall, we've had a transfer of equity to debt of about $90 billion just because of corporate takeovers over the last year. That seems to me to be a negative factor.

Mr. VOLCKER. Takeovers and leveraged buyouts and other restructuring are on that order of magnitude. And, overall, I don't think there's any question that that increases the degree of leverage in the economy as a whole and the risks in the financial system as a whole.

### RAPID GROWTH IN BANK CONTINGENT LIABILITIES

Senator PROXMIRE. Now there have been a number of recent stories about the rapid growth in bank contingent liabilities that are not fully reflected on the balance sheet of the banks. That includes standby letters of credit, financial guarantees, the sale of loans to affiliates and the like.

Someone suggested that the nominally higher capital ratios achieved by the larger banks are not really present when you take a close look at what the banks are really doing.

How serious a problem is this and do you share the concern about off-balance sheet banking; and, if so, what is the Fed planning to do about it?

Mr. VOLCKER. I certainly share the feeling that this is an area that we have to look at and consider what risks there are. We have a very considerable effort underway to get further understanding and to make sure the bankers themselves understand what risks are on or off the balance sheet and take them into account in appraising the adequacy of a bank's capital.

I think there is a tendency, a kind of inherent difficulty, in the kind of capital ratios that we have announced and enforced, and the other agencies have announced and enforced, that what we consider a minimal kind of ratio for any bank is taken as a satisfactory ratio regardless of their condition and the activities of the bank, which it clearly is not. In our analysis, that is a starting point.

We think that any bank ought overall to have that kind of ratio, but they may well need a higher ratio, depending upon the kind of risks they undertake. And one of those risks—or a large share of those risks and an increasing part of the risks—may be off-balance sheet.

It begins to suggest in my mind—and we are working in this direction—a question as to whether we should supplement the overall minimum capital ratio with what might be thought of as a

more sophisticated approach of assessing different kinds of balance sheet and off-balance sheet risks with respect to capital need, and kind of superimposing that kind of analysis on top of a rough and ready minimal overall capital ratio.

Senator PROXMIRE. Mr. Chairman, that's very reassuring. I hope you will move ahead with that.

CREDIBILITY OF TARGET CHANGES

I have one more question. Some monetarist economists believe the Fed is in danger of losing its credibility if it keeps changing its targets to accommodate faster money growth. They argue there is a systematic bias in the way the Fed changes its targets. When money growth exceeds the targets because of an unexpected decline in velocity, the targets are raised. But when velocity increases unexpectedly, the money growth targets are not lowered. Over a longer period, the Fed will create more money than is consistent with price stability. The end result is an inflationary bias in the economy because of Fed policy. Once the market catches on, inflationary expectations and real inflation will rise.

What's your response to that analysis? Isn't the Fed running a substantial risk that it is about to lose its hard-won credibility in the fight against inflation?

Mr. VOLCKER. I was about to say that my answer to that question is: When did we stop beating our wife. There is no question that there are points of possible misunderstanding that arise every time you change your base or raise a target in a situation in which there is legitimate concern about current and future inflation.

The question, in the end, will be whether we were right or wrong and whether the judgment was right or wrong that we are not increasing inflationary risks but rather are adjusting to the facts of the circumstances that suggest that velocity trends may be changing. If you misgauge that and not change your base when the real situation has changed, you would engage, in practice, in a tighter policy than you intended to. You may be hitting the numbers, but the practical effect would be that the policy was not what you intended.

Senator PROXMIRE. Well, the first doesn't seem to apply.

Mr. VOLCKER. We think it does apply here. Now it's a question of how much. If I go back to the earlier experience in 1982 and 1983, the same question was raised. You will remember all of the discussion, by monetarists in particular, that the inflation rate by the end of 2 years after, in mid-1984 was going to take off and we were going to go back to double-digit inflation. We could find the old statements made to that effect; it didn't happen.

I think most monetarists would judge that the adjustment that was made at that time in retrospect, turned out to be the correct adjustment of allowing for a more or less permanent shift in velocity—or however they want to express it—because the price implications now, 3 years later, have not developed in the way that was predicted.

I can't prove that for the current adjustment. We have dilemmas in making a change of this sort and trying to be conservative, and I think we are being reasonably conservative. As I pointed out in my

testimony, rebasing has not allowed for just forgiving this exceptional surge in May and June. We recognize that even now, on the rebased number, if you just looked at those targets in a very technical sense, they were high relative to that range. That expresses our concern that this rate of monetary growth not continue and that is clearly the feeling of the Committee.

At the same time, we recognize that there is considerable uncertainty in appraising this with precision. If things develop in such a way that some of this May-June increase washes out more or less by itself, we would be delighted. It would end some of these questions. We widened the range and provided for the possibility of only something like a 3-percent growth in the second half of the year because we would be delighted if it turned out that some of this increase was temporary. And if the money supply tended to relapse on its own depending upon the circumstances surrounding the economy, that would be quite acceptable to us.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Chairman. I'm sure you're all aware that next week the committee will commence hearings on deposit insurance reform and I'm also certain you would concur that the time is ripe to consider changes in reforming the depository insurance system. So I look forward to hearing the testimony of some of your fellow regulators from the FDIC and the FSLIC next week and once again thank you for your willingness to testify.

Mr. VOLCKER. I was hoping our testimony might be in September.

The CHAIRMAN. It is. I said your fellow regulators will be next week and yours will be in September.

Mr. VOLCKER. Thank you.

THE CHAIRMAN. The committee is adjourned.

[Whereupon, at 11:15 a.m., the hearing was adjourned.]

[Response to written questions with additional material received for the record follows:]

Chairman Volcker subsequently submitted the following in response to written questions from Chairman Garn in connection with the hearing before the Senate Banking Committee held on July 18, 1985:

Question 1: When you appeared before this Committee last February during the first monetary policy oversight hearings for 1985, you pointed out that, while it would be bad for the economy in the long run, sufficiently rapid monetary growth could push down the value of the dollar on foreign exchange markets.

To what extent do you believe that recent declines in the dollar's value are attributable to the surge in M-1 growth since May?

Answer: I would not say that the surge of M1 growth in the past two months has directly contributed significantly to the recent dollar decline. The recent drop in the dollar seems to have been associated in part with the downward movement of U.S. interest rates over the spring and early summer relative to rates in other countries, and in part to changing expectations, influenced to some extent by the further increases in the trade deficit. Interest rates were in turn related to the relatively sluggish behavior of the U.S. economy over this period. The surge in M1 growth at the same time reflected to a degree the increase in money demand as interest rates fell as well as an unusual surge in demand deposit growth perhaps reflecting changing cash management practices or transitory responses to sharp changes in Treasury balances. Accommodation of this increased demand for money helped account for the lower interest rates in the short run, thereby influencing indirectly the value of the dollar. Given the moderation in economic activity and the absence of any signs of additional price pressures, this rapid money growth did not seem to have aroused much concern that a resurgence of inflation was likely. Concerns of that kind related to excessive money growth over time could result in a much sharper drop in the dollar's value.

Question 2: Your statement seems to say that the recent surge in money growth was a result of an increase in the demand for checking account balances and other assets included in M-1.

An alternative explanation would be that M-1 has been growing because the Fed has been pumping reserves into the banking system. This explanation would appear to be more consistent with the fact that the "adjusted monetary base" as calculated by the St. Louis Federal Reserve Bank has also surged since January.

Why do you emphasize the demand for checking account balances, etc., instead of the increased supply of bank reserves in explaining the recent surge in money growth?

Answer: Money growth necessarily represents the interaction of the forces of demand and supply for the assets included in money and the reserves required to back these assets and both forces are relevant in any analysis. Reserves have increased rapidly this year, as the Federal Reserve supplied sufficient reserves to accommodate strong demands for money relative to income. The decision to meet these demands was made in light of conditions in the economy, financial markets, and foreign exchange markets that seemed to indicate that relatively rapid money growth for a time was unlikely to lead to future inflation. I have emphasized the demand side of the market because this expectation rested in part on a judgment that to a significant extent growth in the first half of the year represented a relatively permanent increase in the demand for cash balances and downward shift in velocity. Clearly if the Federal Reserve had not allowed reserves to grow as rapidly, money would have increased less rapidly, and interest rates would have been higher at least for a time. The risk then would be that economic activity would be weaker.

Question 3: On page 14 of your statement, you say:

"We simply do not have enough experience with the new institutional framework surrounding M-1...to specify with any precision what new trend in velocity may be emerging..."

If you can't forecast trends in velocity and you must repeatedly adjust money growth to compensate for unanticipated changes in velocity, what is the value of setting targets for monetary growth?

Answer: There is substantial uncertainty about the trend or cyclical behavior of velocity, as the public and depository institutions adapt to the progressive deregulation of deposit rate ceilings. Even so, we do have some general expectations, based on historical experience and ongoing analysis of current developments, about how money growth is likely to be related to the nation's ultimate goals for spending, prices, and employment under most circumstances. The objectives we establish for M1 growth are based on this analysis, and are given in a fairly wide range to reflect uncertainties about velocity behavior. Barring unusual developments in financial markets and the economy, the Federal Reserve would expect M1 growth within the range adopted to lead to satisfactory economic performance. Money remains a useful guide to policy in that context. It, in effect, provides certain presumptions that should be overturned only in the light of reasonably strong evidence that the expectations about monetary relationships are wrong. Because of the uncertainties involved, I do not believe the monetary targets can be an unbending policy "rule"; rather, monetary growth must be interpreted in light of other financial, economic, and exchange market developments. Clearly, if the relationships between money and the economy were always uncertain and unpredictable, the targeting procedures would have little value, but I do not believe the uncertainties are so great as to justify such abandonment.

Question 4: The following statement appears on page 22 of the Fed's mid-year "Monetary Policy Report":

> "Increases in prices of nonenergy services, which have not been affected nearly as much by import competition, have continued to be substantial..."

Given that increases in prices not subject to import competition remain "substantial", some analysts say that the Fed's rebasing of M-1 and the decision to widen its target growth range mean that the Fed has downgraded the importance of the battle against inflation.

How would you respond to those analysts?

Answer: The rebasing of M1 and adjustment in its range do not imply any lessening of concern about inflation or any weakening in the resolve of the Federal Reserve to pursue a monetary policy consistent with moving to price stability. Indeed, these changes in the M1 objectives would not have been made if the Committee members considered them to be inconsistent with this fundamental goal of monetary policy.

The rapid growth of money in the first half of the year is not expected to result in new pressures on prices partly because a significant portion of the monetary expansion apparently represented relatively permanent buildup in cash balances, partly in response to declining interest rates. With rates ratcheting down owing to a recognition of lower inflation and weakness in the economy, incentives to economize on cash balances diminished and interest-earning transactions accounts became more attractive repositories for savings.

The adjustment to the M1 target was also made in the context of continued moderate current inflation, and with no indications of greater price pressures ahead. Although service price increases continue substantial, prices of goods--which are probably more sensitive to monetary factors--have been relatively flat and sensitive commodity prices have been declining. Wage increases also have remained quite moderate, and there is some slack in labor and final product markets. Inflationary momentum is still untouched in some service areas. I suspect that will decline only gradually, but it's important that it do so.

The use of a second quarter base for M1 assumes that velocity will return over time to more usual patterns--that money demands in the second half will be neither extremely large nor extremely small--and that the money provided in the first half will be largely held as part of the public's saving and not employed to generate inflationary demands for goods and services. To help ensure that inflationary pressures remain subdued, the new M1 range entails a substantial moderation in growth from the first half of the year. Moreover, the width of the range recognizes some uncertainty surrounding the judgment about the effect of the more rapid expansion of the money stock in the first half of the year. The low end of the new range provides for a very marked slowing of M1 should a subsequent

pickup in velocity seem to indicate more active use of these balances.

Finally, I would note that the Committee adopted a tentative range of 4 to 7 percent for M1 in 1986, lowering the upper limit of the rebased 1985 range; lowered the upper limit of the M3 range for next year by one-half of a percentage point; and lowered the range for credit growth by a full percentage point. These decisions also affirmed the Committee's intention to move toward reasonable price stability over time while encouraging sustainable economic growth.

Question 5: On pages 12 and 13 of your statement you draw a parallel between the recent surge in money growth after a drop in interest rates and the experience of 1982-83.

You do not point out, however, that the earlier surge in money growth was followed by a surge in real economic growth beginning in the second quarter of 1983.

The Federal Reserve's projections for real growth later this year and in 1986 do not show a speedup like that in 1983 and 1984.

Why won't the recent surge in money growth be followed by accelerating economic growth as in 1983?

If the economy should begin to grow faster later this year than you now expect, will you allow money to grow faster than the upper boundary of the new target range?

Answer: We do expect a pickup in real economic growth in the second half of the year, as I indicated in my discussion of the FOMC members' projections, but not to the same degree as occurred in 1983-84. The surge in money growth extended for a considerably longer period in the earlier episode; over the year, from the third quarter of 1982 through the third quarter of 1983, M1 grew 13.1 percent, with growth at or above a 10 percent annual rate in each quarter. The current burst in money growth has been two quarters in duration, has been at around a 10-1/2 percent annual rate, and followed two quarters of relatively slow growth. The earlier episode coincided with the trough of our deepest post-war recession, and very rapid economic growth could be accommodated without generating renewed inflationary pressures.

Although somewhat faster growth in the economy than we have experienced in recent quarters is expected and welcomed, clearly a repeat of the extent of the earlier expansion is unlikely, given the lower margins of unutilized resources at present. Should the economy grow faster than expected in the second half of the year accompanied by a tendency for M1 to remain above the new target range, my general expectation would be that the Federal Reserve would attempt to constrain money growth to its range. Still, our exact response would depend on the surrounding circumstances, including the behavior of other monetary aggregates, any indications of possible pickup in inflation, and the behavior of the dollar on exchange markets. But the situation would differ fundamentally from that in the first half of this year when tolerance of monetary expansion above the target range occurred in an environment of relatively slow economic growth and falling velocity.

Question 6: In your statement you indicate that the high value of the dollar on foreign exchange markets was one reason the Fed did not move to slow the growth in M-1 during May and June: i.e., action to slow money growth would have raised interest rates and driven the dollar even higher.

Given the recent declines in the value of the dollar, should financial markets assume that the Fed now has more leeway to move to offset above-target growth in M-1?

Answer: The dollar's value is one of the factors we look at in evaluating the likely effects of money growth on the economy and inflation. This spring, money growth well in excess of the Committee's paths was accompanied not only by a relatively strong dollar, but also by sluggish economic activity--especially in the industrial sectors--while inflation remained moderate. Under these circumstances, decisive action to restrain money growth could well have pushed the exchange rate, and also interest rates, higher with further depressing effects on output. The recent drop in the dollar does in that sense provide a little more leeway, other things unchanged, to restrain M1 growth within its range. But, in practice, the dollar would be only one factor among many in assessing responses to money growth--and policy would necessarily have to consider other developments in financial markets, the business outlook, and overall price pressures.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MATTINGLY

Chairman Volcker subsequently submitted the following in response to written questions from Senator Mattingly in connection with the hearing before the Senate Banking Committee held on July 18, 1985:

Question 1: Monday's Wall Street Journal reported the following news quip: "Minutes released Friday (July 12) show that the Fed's policy setting arm voted 11-1 at its May 21 meeting to leave monetary policy unchanged." What's disturbing to me about that report is the fact that the Fed withheld the May 21 meeting minutes for almost 7 weeks. I personally have problems with the withholding of such information and for such a long period of time. What is the Fed's justification for such action?

Answer: While the FOMC's basic monetary policy decisions with respect to growth rates for the year for monetary and credit aggregates are reported to the public promptly, its decisions concerning the short-run implementation of monetary policy are not released until shortly after the subsequent meeting of the Committee. This schedule is adhered to because of concern that earlier release of the decision--while it was still controlling for open market operations--would focus more attention on the short-run aspects of monetary tactics and foster even more speculation about the day-to-day implementation of policy, resulting in greater short-run swings in interest rates and market volatility.

The information in question takes the form of instructions to the Federal Reserve Bank of New York specifying the criteria to be used in carrying out open market operations in

the period until the next FOMC meeting. These instructions are necessarily conditional in nature; that is, the actual stance of the Federal Reserve in supplying reserves will depend on the data that become available on growth in the money stock and information about the economy and financial markets as well. The so-called "directive" therefore does not give unequivocal instructions about how bank reserve conditions might evolve over a span of several weeks. The danger is that market participants would not adequately recognize the conditional and judgmental nature of the directive. In trying, with a false sense of certainty, to outguess the Federal Reserve, they would tend to impart even wider swings in domestic and international market conditions than we now experience. It would be especially difficult for the Federal Reserve to make relatively minor, probing adjustments to its stance in supplying reserves without provoking market over-reaction.

Immediate release of the directive would also tend to focus attention on the short-run tactics of monetary policy, rather than the long-run strategy that is important to achieving national objectives for output, employment, and prices. Decisions bearing on these more important strategic questions are released within a few days after they are made in February and July, and are accompanied by a report to Congress and testimony spelling out fully the Federal Reserve's assessment of the economy and the reasons for its policy choices. Quite properly, they are the subject of intense scrutiny and debate, both within Congress and in the public at large. Immediate release of the FOMC's short-run decisions as well could deflect needed and appropriate attention from these more fundamental issues of monetary policy.

Question 2: Since December, M1 has risen at a super fast annual rate of more than 12 percent, roughly double the Fed's target range for 1985 of 4 percent to 7 percent. I assume that the overshooting of the targets was in part to stimulate economic growth. I have no problem with that policy as long as inflation continues under control; nonetheless, what is the lag time between money growth as a stimulus and the resulting economic growth?

Answer: Money growth affects the economy over a considerable period and to varying degrees, with the timing and extent depending on a number of factors, including the state of the economy and financial markets, price and interest rate expectations, and changes in the demand for money not directly related to transactions uses of money balances. Some have observed that an acceleration of money growth seems to have its greatest impact on business activity in around two quarters, but this is not necessarily consistent. The timing and extent of any subsequent effect on inflation are also quite variable, though most analysts believe the lags are longer than for real economic activity, on the order of 18 to 24 months. However, in that respect, it should be noted that the very rapid money growth of 1982-83 was not followed by a pickup of inflation. The economy is just too complex, and the route by which money affects spending and prices too circuitous and too loose, to have confidence in estimates of a very precise relationship between money and the economy.

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The overshoot of M1 growth relative to the ranges was tolerated in the first half of the year given the drop in velocity and the sluggish economy, in an effort to encourage economic growth. FOMC members do expect a pickup in economic activity in the second half of the year, but with inflation remaining subdued, a substantial proportion of the increase in money the first half is thought to represent relatively long-term additions to cash balances.

Question 3: Pending before the Fed is an application by Citicorp to form a subsidiary in South Dakota to sell insurance. Has the 91-day period begun to run, when do you anticipate consideration of the application, and how will you rule on the application?

Answer: On July 31, 1985, the Board denied the application by Citicorp to acquire American State Bank, Rapid City, South Dakota, and thereby to engage in a broad range of insurance activities, including underwriting life insurance and acting as agent for the sale of all types of insurance. The Board held that the proposal was in reality an acquisition by Citicorp for the purpose of engaging in insurance activities otherwise prohibited for bank holding companies under the Garn-St Germain Depository Institutions Act of 1982.

Question 4: An economist from Irving Trust Company was recently quoted in USA Today as follows: "I think the (Federal Reserve Board) has in mind a dollar level that's about 10 percent lower than where we are now." Is that statement accurate and how will the Fed accomplish such a reduction?

Answer: Neither the Federal Reserve Board nor the FOMC has in mind any particular reduction in the exchange value of the dollar. As noted in our Report to Congress, the projections made by FOMC members and the other Reserve Bank Presidents are based on an assumption that the exchange value of the dollar will not deviate substantially from its recent levels. That, I should emphasize, is not the same as a forecast, and the experience of recent years has reemphasized the difficulty of any such forecast. Much would depend upon surrounding circumstances in evaluating responses to significant changes in the value of the dollar.

Question 5: Assuming a 10 percent reduction of the dollar was achieved, what would be the effect on our balance of trade and the federal deficit?

Answer: It is difficult to quantify with any confidence the effects of a change in the exchange value of the dollar, especially without specifying the causes underlying the dollar's assumed decline. As a very rough order of magnitude, standard econometric analysis suggests an exogenous 10 percent reduction in the dollar to result in a reduction in the U.S. trade deficit of more than $5 billion after one year and of more than $15 billion after a longer adjustment period. Other things equal, nominal GNP might be a bit higher, and federal tax revenues might be enhanced. However, unless some other steps were taken independently to reduce the budget deficit, the reduction in the capital inflow associated with the reduction in our trade deficit would tend to add to pressures in U.S. financial markets and on interest rates. The effects on the net budget deficit would then not be large.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE

Chairman Volcker subsequently submitted the following in response to a written question from Senator Proxmire in connection with the hearing before the Senate Banking Committee held on July 18, 1985:

Question: I recently wrote to Secretary of the Treasury Baker about our international debt strategy and among other things asked what effect the Administration's new lower economic growth forecast would have on the ability of the Latin American debtor nations to service their debt.

The Secretary responded yesterday that "slower growth in the U.S. would lead to lower export growth rates from such countries," but said that difficulty would be offset by lower U.S. interest rates. He said the Administration estimates as a rough rule of thumb that a "one percentage point drop in dollar interest rates would result in savings due to lower interest payments far exceeding the slower growth in exports to the United States which would result from 1 percent slower U.S. growth rate."

I was very surprised by this "rough rule of thumb calculation" as I understood most observers felt each percentage point growth in the OECD countries could add $12 billion or so to debtor country export earnings as compared to the $4 billion or so they would save from each point drop in interest rates.

* Can you comment on the Treasury's rule of thumb calculation? Do you think that a growing U.S. economy is absolutely critical to a favorable solution of the third world debt problem?

* If so, for how much growth must we maintain and over what period of years?

Answer: I cannot comment directly on the Treasury's calculations, since I do not know the details. I am inclined to think that the negative impact on the export earnings of non-OPEC developing countries of one percent lower economic growth in the United States may be about half as large as the

positive impact from one percent lower dollar interest rates. Whether such an offset is substantial is, of course, a matter of judgment. Moreover, such calculations, which are rough at best, vary considerably depending on which developing countries are included, how changes in growth rates or interest rates are assumed to be brought about, and how long they persist. As for your reference to the relative effects of OECD growth and interest rates, I do not recognize the figures you cite, and I am inclined to feel--with all the caveats just noted--that the figure for improved export receipts, in particular, overstates to a considerable degree the impact on exports of non-OPEC developing countries of one percent faster growth in the OECD area.

It is clear, however, that continued growth in the United States and in other industrial countries--with continued access to those growing markets--is essential to the economic well-being of developing countries. What is more important than achieving any particular growth rate, I believe, is that growth in the United States and elsewhere be sustained over the long term in an environment of low and stable inflation rates. In such an environment, developing countries can benefit from both growing demand for their output and reasonably low interest rates.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE

Chairman Volcker subsequently submitted the following in response to written questions from Senator Riegle in connection with the hearing before the Senate Banking Committee held on July 18, 1985:

Question 1:

Real Estate Market

In your prepared testimony you point out that "spending for nonresidential construction, particularly offices and stores, continued at strong rates in the first half of 1985, and construction contracts rose further despite very high vacancy rates in many parts of the country." (p. 10--emphasis added.)

I am concerned about a possible over-capacity in the real estate market and especially so in light of remarks made earlier this week by Eric Hemel, the director of the office of policy and economic research at the Federal Home Loan Bank Board. This senior official was widely quoted as saying that because of a softening market for office buildings and other commercial properties "we're in for a debacle that will take a number of savings institutions and commercial banks with it."

He was also quoted as saying in unusually blunt remarks that "There are some banks whose capital is significantly impaired, and who may be in a true economic sense underwater, who are still doing business." He added, "That means trouble down the line."

* (a) How concerned are you that between deferral of losses from farm loans, real estate loans, energy loans and Latin American loans, a lot of respectable financial institutions are dangerously close to, or actually are, under water?

Answer: Many banks have failed because of problems encountered in the loan areas mentioned, and a large number of others are now experiencing difficulties of greater or lesser severity--over 1,000 banks are now on the FDIC's problem list. The question seems to imply, however, that many banks, not on

the FDIC's list, have serious problems which they have been permitted to avoid recognizing. That is not the case. Banks have been required to charge off bad loans on their books and to build up loan loss reserves and capital to position themselves to deal adequately with future loan problems. Thus, most if not all banks whose current financial statements show them to be in healthy condition should be able to weather problems that may arise in the future.

* (b) How likely are we to see a serious overcapacity of office buildings in areas such as Denver, San Diego, Phoenix, Columbus, Houston, Miami and Dallas, and what are likely to be the ripple effects throughout the economy?

Answer: Office vacancy rates have been soaring in many major cities around the country, and with much space still under construction, serious gluts seem a distinct possibility in a number of locales. Office building appears, unfortunately, to be following its all-to-familiar boom-bust pattern. It is impossible to predict what the precise economic effects of a decline would be: much would depend on the severity of the downturn and on whether the general economic circumstances at the time would be such that the capital freed up by reduced office construction would be an effective stimulus to spending of other types.

As a bank supervisor, I of course have a particular interest in the financial side of the office building boom. I have seen more deviations on the parts of lenders and equity investors from traditional and prudent financing practices than I would like, and I believe that the calculations underlying many projects have rested too much on unwarranted inflation expectations. We have been urging the institutions we oversee to exercise due caution in their lending, so as to avoid excessive credit risks and in the process avoid giving impetus to excessive speculation in this market.

Question 2:

Withholding Tax

In 1982 the 20 percent withholding tax was repealed for foreign investment on T-bills, notes and bonds. Subsequently foreign demand for U.S. dollars increased; the value of the dollar on international money markets climbed; and U.S. exports were hurt.

* On balance what have been the net effects of repealing the withholding tax and specifically why should foreign investors be allowed to invest in the United States tax-free while U.S. citizens have to pay taxes?

* Some commentators have suggested that reinstituting the withholding tax would help lower the demand for U.S. dollars; lower the value of the dollar on international markets; help our balance of payments deficit; and help the U.S. compete in world markets. What is your reaction to these views?

Answer: Even before the repeal of the 30 percent withholding tax, U.S. tax treaties that have been negotiated with most major foreign countries effectively enabled many foreign investors to avoid paying U.S. tax on interest earned in this country. Thus, repeal of the tax probably had only a minor effect on incentives to invest here. Tax incentives to hold securities are provided, as well, to U.S. investors, as with IRA or Keogh plans.

Since it is not likely that repeal of the withholding tax has had a major impact on the dollar or on U.S. international payments, reinstituting the tax is not likely to have a major impact either.

Question 3:

Debt

What do you see as the short-term and longer-term economic implications of our current budget deficit, trade deficit, increased corporate debt and record consumer debt?

Answer: All of these items give rise to risks and uncertainties in the economic outlook, short or long term. Clearly, the sorts of imbalances we see in our internal fiscal posture and in our external accounts are unsustainable and are incompatible with strong, balanced economic growth and rising living standards over the long run; moreover, they heighten the risks in the near term of financial pressures that could disrupt the ongoing economic expansion and exacerbate the strains already present in our financial system. I also view the tremendous growth of corporate and consumer debt as a cause for some concern, for heavy debt burdens imply a greater vulnerability in the event of unanticipated shocks; we have indicated, in our monitoring ranges for debt growth this year and next, our expectation that these trends in private indebtedness will be moderating somewhat in the period ahead.

Question 4:

Interest Expense and the Gross National Debt:

I have been told that if we only add interest expense to the gross national debt (GND), meaning we are able to balance all other federal obligations with budget receipts, the GND would still grow astronomically. Some estimate that the GND would grow to approximately $7 trillion by the end of the century ($1.8 trillion x 10% compounded over 15 years = $7.5 trillion).

* (a) Assuming anywhere near this rate of growth in GND and the fact that the Federal Reserve has traditionally kept its total money supply figures above the GND, what are the implications for future inflation?

Answer: Whether it is reasonable to assume such rapid growth in the national debt depends, of course, in large measure on one's optimism or pessimism about our ability to deal with the deficit problem. The example certainly does underscore in a dramatic way one important point: the sizable interest payment element in the budget means that delays in reducing the deficit lead quite literally to a compounding of the problem!

As regards the implications for inflation, you are quite right in suggesting that excessive money creation would tend to raise the general level of prices. But there is no automatic or mechanical connection between the rates of growth in federal debt and the money supply, and I believe that we will be able to maintain sufficient control over monetary expansion to avoid reinvigorating inflation. This is not to say that rapid increase in the federal debt is benign, however; to the

contrary, it would tend over time to displace other assets in the public's wealth portfolio, with distinctly negative consequences for capital formation, productivity, and living standards.

* (b) What effect will such GND growth have on our retired population including individuals on fixed pensions and Social Security?

Answer: If inflation is held in check, then those living on fixed incomes might not be especially hard-hit by sustained rapid growth of the national debt. Rather, because of the effects I noted above, it is those who are now young and generations yet to come who most likely would have to pay the greater price.

* (c) What projections and assumptions has the Federal Reserve Board made, or would you now make, with respect to GND growth over the next 15 years through the year 2000?

Answer: The Board has not made such long-range projections--and I'm not sure that we can do so usefully because so much depends on the actions of the fiscal authorities, which we are in no special position to prognosticate. I do believe, though, that the Congressional Budget Office's discussion of debt, interest payments, and the deficit in its February report (The Economic and Budget Outlook: Fiscal Years 1986-1990) highlights in a sobering way the problems that your question addresses.

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

July 26, 1985

Dear Senator Garn:

Enclosed is my statement on monetary policy, submitted for the record of the mid-year monetary policy oversight hearings. I appreciate the opportunity to present the Administration's views on this important subject.

Sincerely,

Beryl W. Sprinkel

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
U. S. Senate
Washington, D. C. 20510

cc: The Honorable William Proxmire
U. S. Senate
Washington, D. C. 20510

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

Statement

of

Beryl W. Sprinkel
Chairman
Council of Economic Advisers

Submitted for the Record

to the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

July 26, 1985

Chairman Garn, Senator Proxmire, distinguished members of the Committee, I am pleased to have the opportunity to submit for the record this statement of the Administration's views on monetary policy.

Long-Term Objectives

The monetary policy objectives of the Administration are completely consistent with the stated policy goals of the Federal Reserve. Over the long run, the Administration's objective is to continue to reduce the inflation rate until, ultimately, price stability is restored. The decline in inflation that has occurred over the past four years has been a significant achievement, but we believe that it would be a serious mistake for the government--and for the American public--to accept as permanent our current inflation rate. While 3 to 4 percent inflation is certainly a substantial improvement over the double-digit rates of the late 1970's, it is also not price stability.

If we are to preserve the gains already made in reducing inflation and ultimately extend those gains until true price stability is re-established, the rate of money growth must be gradually reduced downward over time. The historical, long-term relationship between money growth and inflation is one of the most widely-tested and reliable of all economic relationships. Chairman Volcker and other

Federal Reserve officials have on many occasions restated and reaffirmed their intentions to pursue such a policy and the Administration fully supports that objective.

The transition of the economy to a reduced inflation rate has been difficult; for some sectors of the economy, that adjustment has been particularly painful and, in some cases, is not yet complete. I do not believe that the economic dislocation associated with reducing inflation was inevitable; a more gradual deceleration of money growth than actually occurred, and a more stable and predictable pattern of money growth during the deceleration, would have reduced the uncertainty about monetary policy, implied lower interest rates, and facilitated a more orderly transition to lower inflation. This was the premise of the Administration's original recommendation in 1981 that money growth be gradually decelerated in a smooth and predictable path to a noninflationary pace.

Even under the best circumstances, moving an economy from an inflationary path to price stability is a difficult and potentially costly process. Because it requires a fundamental readjustment of public behavior and thinking, price stability cannot be restored overnight. Once inflation and inflationary expectations become embedded in

an economy, investment, saving, spending and pricing decisions are all profoundly affected by expectations of inflation. These expectations--and the economic decisions based on them--must be realigned in the process of restoring price stability.

In recent years, we have seen important progress in the basic attitudes and economic behavior that is characteristic of an inflationary economy. The fact that we are yet to enjoy all the economic payoff from a lower inflation rate only underscores the need to persist in our efforts to contain inflation. With the worst of the transition to lower inflation behind us, it would be particularly tragic to allow inflation to reaccelerate again, necessitating yet another painful period of readjustment to reduce inflation at some point in the future.

Short-Run Concerns

While our commitment to long-run price stability is firm, the Administration is concerned about shorter-term fluctuations in the rate of money growth. Administration officials believe that wide swings in money growth have important, adverse effects on economic performance. It is widely recognized that it is not technically feasible for

the Federal Reserve to avoid week-to-week or month-to-month changes in money growth; it is also clear that those short-term fluctuations have little or no economic impact. Administration concerns focus on a pronounced pattern of many months of excessive money growth, followed by a prolonged period of very slow money growth. We believe that this stop-go pattern of money growth is detrimental to the economy for two important reasons.

First, sharp swings in money growth that last 5 or 6 months or more have a significant impact on economic activity. The initial effect of a change in money growth is to induce a similar change in the real economy. Thus, an acceleration of money growth provides a short-term stimulus to the economy and a deceleration of money growth depresses economic activity. This is not to say that every short-term wiggle in money growth alters the course of the economy. But fluctuations in money growth that persist for 5 or 6 months or longer cause similar fluctuations in economic activity. This relationship is illustrated in the attached chart which shows the two-quarter rate of change in M1 growth and quarterly real GNP growth.

The short-run relationship between changes in money growth and real economic activity is by no means precise

with respect to either timing or intensity. In the short run, many other factors affect the real economy and the lags in the effect of changes in money growth vary, depending upon economic conditions, expectations and previous monetary policy. Nevertheless, the direction of influence on the economy of a sustained acceleration or deceleration of money growth is clear. Therefore, a monetary policy that allows prolonged swings in money growth causes -- or at least adds to -- fluctuations in economic activity.

The second reason that volatile money growth is of concern relates to expectations and the outlook for inflation. Erratic money growth increases the uncertainty about monetary policy, about the long-run trend of money growth, and consequently the outlook for inflation. This increased uncertainty must be compensated for by higher interest rates. There is considerable empirical evidence on the effects of monetary volatility on uncertainty and financial markets which supports this view. In addition, volatile money growth adds to the uncertainty and speculation about the short-term economic outlook as well as the Federal Reserve's policy response to money growth and/or economic performance. While difficult to quantify, it is likely that such speculation and uncertainty has additional, destabilizing effects in financial markets.

The path of monetary expansion over the past year provides an example of the Administration's concerns about short-term monetary fluctuations. Even though the average rate of M1 growth during 1984--5.2 percent--was consistent with our long-term goal of controlling inflation, and although M1 generally was within its target range during the year, those desirable average results mask less desirable, prolonged swings in M1 growth. After growing at a 7.3 percent compound annual rate for the first 6 months of the year, the Federal Reserve slowed M1 growth substantially; the result was a period of near-zero M1 growth from June to October.

Thus, the direction of influence of monetary policy beginning in the late spring of 1984 was clearly one of restraint. The slowdown in economic activity over the past three quarters is therefore at least partially attributable to the influence of monetary policy. Since late 1984, M1 growth has accelerated to a rate which, if allowed to continue, would not be consistent with our long-run goal of price stability. Thus, money growth so far in 1985 implies the need for a slowdown in money growth which, if not successfully engineered as a very gradual deceleration, will pose yet another risk to sustained economic growth.

It is these repeated policy-related risks to economic performance that Administration officials find unacceptable. It is because of the economic risks of highly variable money growth that the Administration has continuously recommended a more stable and predictable path of money growth in the short run, as the trend of money growth is reduced over time. Wide fluctuations in money growth can and should be moderated. The Federal Reserve has the technical capacity to control money growth precisely enough to provide for a more stable, and predictable pattern of monetary expansion. The Administration believes that a reduction in the variability of money growth would minimize the policy-induced fluctuations in real economic activity, reduce the speculation about monetary policy and the outlook for inflation, and generally enhance the stability of financial markets.

The Uncertainty About Velocity

Financial deregulation in recent years has caused uncertainty about the relation between money growth and nominal GNP. It is possible that the inclusion in M1 of interest-bearing transactions accounts will prove to have altered the relation between M1 growth and nominal spending. The Administration is sensitive to these concerns

and agrees that the Federal Reserve should be vigilant to empirical evidence of a change in the trend growth of velocity (the ratio of nominal GNP to the money supply).

It should not be inferred, however, that the Administration supports attempts to fine-tune money growth to short-term changes in velocity. On a quarter-to-quarter basis, velocity is, and always has been, highly volatile. It is therefore dangerous to draw policy conclusions from short-term movements in velocity. Those of us who have emphasized monetary control and targeting as an operating principle for monetary policy never did so on the premise that velocity was well-behaved on a quarter-to-quarter basis.

As a matter of arithmetic, short-term fluctuations in velocity will be greater whenever money growth is highly volatile. For example, velocity fell about 5 percent during the first two quarters of 1985. Many have concluded that this justifies or necessitates more rapid money growth. Based on past money growth, however, slow velocity growth in the first part of 1985 is not particularly surprising. The slowdown in economic activity is partly attributable to the monetary slowdown in mid-1984; the subsequent rapid acceleration of M1 growth in late 1984 and early 1985 all

but guaranteed that velocity would be weak early in 1985. Since velocity is simply the ratio of nominal GNP to the money supply, a decline or slowdown in velocity is the arithmetic result of the combination of weak GNP growth and high money growth. Thus fluctuations in money growth can induce fluctuations in velocity given the lagged relation between changes in money growth and economic activity. Attempts to tailor money growth to such policy-related fluctuations in velocity implies a short-term fine-tuning approach to policymaking that the Administration does not endorse.

Setting these short-term considerations aside, however, a more fundamental question remains: has financial deregulation altered the policy behavior with respect to M1 holdings and spending? One can plausibly argue that the interest-bearing deposits now included in M1 function as saving as well as providing transaction functions, and therefore that the public will hold more M1 balances per dollar of spending. If so, trend velocity growth will be lower and our standard for prudent, noninflationary money growth that is sufficient to accommodate real growth must be increased.

We must be extremely cautious, however, in drawing such conclusions because if we are wrong, what is at risk is a reacceleration of inflation. It is for this reason that I am very wary of drawing inferences about the long-term behavior of velocity from its short-term movements, particularly in an environment of highly volatile money growth.

Until sufficient time passes that we can draw firm conclusions about the effect of financial deregulation on velocity, uncertainty will remain. It is important to recognize, however, that there is always uncertainty surrounding policymaking; that is, any policy that is adopted implies some risk to the economy if unforeseen developments emerge. However, it is the job of prudent policymakers to adopt policies that minimize the associated risk to economic performance. In the current environment of uncertainty about velocity, it is clearly not a risk-minimizing policy either to ignore the possibility that financial deregulation has altered the basic relationship between money growth and nominal spending, or to base money growth on an extreme-case assumption that velocity growth will be substantially lower than its historical norm.

Summary and Recommendations

The Administration has consistently endorsed the long-term deceleration of money growth that is needed to reduce inflation, but has recommended that the deceleration be gradual and predictable, in order to avoid the economic fluctuations associated with large, prolonged swings in money growth. Consequently, the Administration cannot support monetary policy actions that would lead to higher money growth over time or that increase the potential for increased volatility in money growth.

The over-shooting of the Federal Reserve's target range in the first half of the year poses a difficult policy dilemma. If money growth continues at the pace recorded so far this year, a subsequent reacceleration of inflation is inevitable. While uncertainty about velocity behavior exists, recent monetary expansion implies a significant acceleration in nominal GNP growth in the months ahead, even if velocity does not grow at all over the second half of the year.

Thus a transition to slower money growth is required now to limit the threat of future inflation and prevent inflationary expectations from rising. However, the significant and protracted deceleration of money growth that

would have been necessary to bring M1 into its original 4 to 7 percent target range would have subjected the economy to a period of strong monetary restraint and would very likely have caused an economic downturn. In this context, the Administration understands the Federal Reserve's decision to rebase the M1 target range to the second quarter. Given the money growth that has occurred so far this year and the economic risks associated with returning M1 to its target range, the rebasing appears to be the least risky policy alternative available at this time.

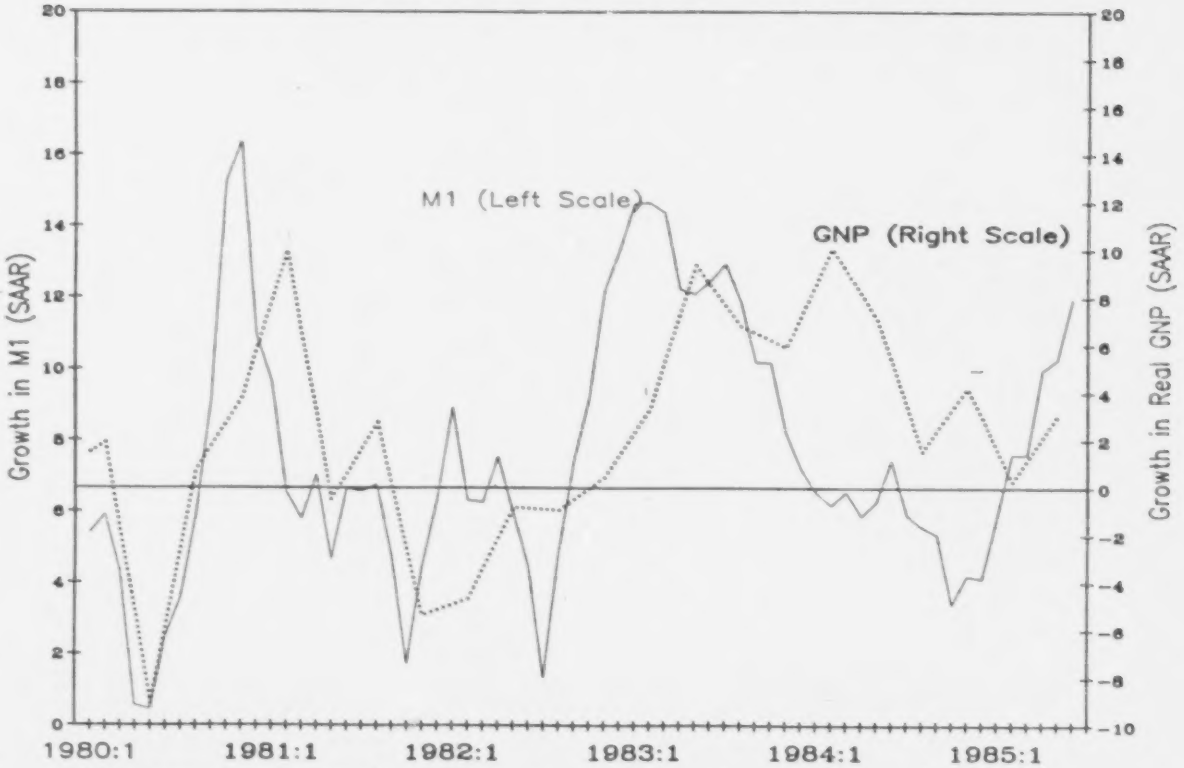
As was explained in detail in the 1985 Economic Report of the President, the Administration is in principle opposed to allowing the base period for monetary targets to be shifted. The rebasing and redefinition of target ranges is not new. The Federal Reserve rebased (upward) its target ranges frequently over the 1974-80 period. This introduced an inflationary bias into monetary policy as rapid money growth was permitted within escalating target ranges. The purpose of monetary targets is to impose long-term monetary discipline. There is no such monetary discipline if target ranges are abandoned, rebased on redefined when exceeded.

We are hopeful that monetary growth will gradually decelerate in the period ahead, in order to limit inflation

and avoid a monetary shock to the real economy. We expect that future money growth targets will be consistent with the long-term deceleration of money growth that is necessary for price stability and hope that the increase in money growth allowed by the rebasing of the 1985 target range is gradually offset in subsequent years.

The Federal Reserve has also widened the target range from 4 to 7 percent to 3 to 8 percent. This target range is wider than any previous range adopted by the Federal Reserve. Wide target ranges permit substantial variability of money growth within the range. The long periods of flat money growth that are disrupting to the real economy are often permissible with an excessively wide target. In general, the Administration recommends more stable money growth than is implied by such a wide target range.

# M1 AND REAL GNP GROWTH




M1 growth is a 6 month average, at annual rates.
Real GNP growth is quarterly, at annual rates

STATEMENT OF THE HONORABLE MANUEL H. JOHNSON
ASSISTANT SECRETARY (ECONOMIC POLICY)
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
JULY 18, 1985

## I. INTRODUCTION

The Treasury Department welcomes this opportunity to present its views on monetary policy and recent monetary developments. In general, we agree with the broad outlines of the approach taken by Chairman Volcker in his July 17 testimony before this Committee. In particular, the decision to rebase the M1 target range on the average level of the money supply in the second quarter would appear to have been correct under the circumstances. The rebasing exercise removed the threat that the Federal Reserve might feel obliged to force M1 back within the original target range -- a clearly impractical undertaking. With the rebasing, successful adherence to the new targets appears to be a realistic possibility and given some recovery in monetary velocity should be consistent with a fairly strong second-half expansion of the economy. While the decision to rebase makes sense in this short-run context, it will be extremely important for the Federal Reserve to avoid any sustained period of overly rapid monetary expansion that would bring inflation back into the picture. The experience of the last two decades in this country and a wide range of experience abroad suggests very strongly that the appropriate time to fight inflation is long before the inflationary process has been allowed to build up momentum.

Granted that the recent modification of the monetary targets is defensible, the erratic short-run pattern of monetary growth in recent years -- of which this is only the most recent episode -- remains a source of some concern to the Administration. It would be highly desirable if such wide monetary swings could be avoided in the future. It must be conceded that the Federal Reserve has faced a difficult set of circumstances in recent

years. Institutional change has been rapid in the financial area, monetary velocity has become an increasingly erratic parameter and the international monetary dimension has been an additional complicating factor. But it is doubtful that these and other special factors are sufficient to account for the fact that since 1980 M1 has been outside the target range much more frequently than it has been within and that on a 13-week basis M1 growth has ranged from a high of a 17.7 percent annual rate to a low of -1.3 percent.

The Administration has consistently supported the Federal Reserve in its efforts to control inflation and promote growth. It will continue to do so. But there are some respects in which the recent record of monetary policy clearly stands in need of improvement. It may assist in clarifying these issues to state explicitly some general principles by which the Administration believes monetary policy should be guided.

## II. GENERAL STATEMENT OF PRINCIPLES ON MONETARY POLICY

The Administration desires a steady, moderate rate of growth in money and counts on the Federal Reserve to carry out that responsibility. There have, of course, been occasional differences of opinion between the Administration and the Federal Reserve on specific issues of monetary technique; but there has been no difference of opinion as to the importance of controlling the growth of money over the longer run.

Agreement is general within the economics profession that over the long run inflation is a monetary phenomenon and inflation can persist only when it is accommodated by monetary expansion. This is one of the few theorems in economics which seems to have been firmly established. Therefore, control over monetary growth is absolutely essential as a long-run proposition if inflation is to be avoided. This has been a basic guiding principle of the Administration's view of monetary policy and it will continue to be.

The Administration has also felt that it is highly desirable for monetary policy to avoid short-run disturbances to the economy and to promote as low a level of interest rates as possible. It must be conceded, however, that there is far from unanimous agreement within the economics profession on the extent to which short-run variations in monetary growth exert predictable effects upon economic activity and real output. Because the short-run relationship between money and economic activity is looser and

less exact than the long-run relationship between money and the price level, the Administration has favored a cautious and gradualist short-term approach in the monetary area rather than rigid application of a monetary rule.

The original Administration plan in the monetary area to deal with double-digit inflation called for a gradual deceleration of monetary growth extending over the period from 1980 to 1986. Instead, there was an abrupt deceleration of monetary growth by the Federal Reserve in 1981 which triggered and intensified the 1981-82 recession. Subsequently, there have been a series of abrupt accelerations and decelerations in monetary growth as shown in Chart 1. The most recent episode was the virtual cessation of growth in M1 in the second half of 1984 followed by a burst of double-digit growth in M1 in the first half of this year which is still continuing to the present time.

This is not a desirable pattern. It tends to force the economy into a stop-go pattern instead of a phase of steady expansion. In addition to exerting undesirable effects on output and employment, a volatile pattern of monetary growth increases financial market uncertainty and may build an uncertainty premium into the entire structure of interest rates. Econometric work by the Treasury has suggested that this has been an important influence in recent years, holding interest rates at an earlier stage of the expansion some 200 to 300 basis points higher than they might have been if the pattern of monetary growth had been smoother.

A consistent short-run relationship between changes in monetary growth and subsequent changes in economic activity as measured by nominal GNP depends upon the existence of some degree of stability in monetary velocity (the turnover of money). As shown in Chart 2, the M1 velocity growth trend was positive throughout the period following World War II. (Monetary velocity displayed a generally negative trend in the late 19th and early 20th centuries.) A 3 percent annual increase in velocity is frequently taken as a rule of thumb estimate of the postwar trend. Research at Treasury suggests that the regularity of any stable trend in velocity is open to question. That point of view has gained force with the very erratic behavior of velocity in recent years. The reasons for the instability of velocity are complex and not yet fully understood.

The break in the velocity trend has also apparently disrupted shorter-run cyclical patterns in monetary velocity as shown below.

Changes in Monetary Velocity during Postwar Expansions
(in percent)

| | Average of Previous Expansions | Current Expansion |
|---|---|---|
| 1st four quarters | 5.5 | 0.0 |
| 2nd four quarters | 3.3 | 4.1 |
| 3rd four quarters | 4.2 | -5.1 |

NOTE: Five previous expansions for the first eight quarters, four for the final four quarters. First half of 1985, which constitutes the ninth and tenth quarters of the current expansion, is expressed at an annual rate.

The recent instability of velocity has meant that a rigid and literal adherence to the original monetary targets would have been unwise. But it would be equally unwise to assume that monetary velocity will necessarily persist in its recent sluggish pattern. All that is known with certainty is that during a period of rapid institutional change in financial markets and continuing disinflation in commodity markets, velocity has grown much less than in the past. Rebasing of the monetary targets is an appropriate step to take under the circumstances, but the future behavior of velocity will require careful attention. A cautious approach should be followed since the growth rate of money will need to be cycled down if it becomes apparent that velocity is returning to growth rates more consistent with the postwar trend.

The Administration adheres to the view that the long-run rate of growth in M1 must be held to moderate proportions since it is the primary long-run determinant of inflation. In the short run, monetary volatility has been excessive in recent years and needs to be reduced. The best initial approximation for the monetary authorities should be as stable a rate of growth in M1 as they can achieve along the upper band of the rebased target range.

Monetary policy is an extremely important part of the Administration's overall economic strategy. Properly executed, monetary policy can help provide a non-inflationary environment and assist in the promotion of economic growth. But monetary policy is far from the only influence on the economy. There is a clear

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need at the present time to get Federal spending under better control and thereby to move the budget deficit in a downward direction. It is equally necessary to proceed with tax reform and similar steps to enhance incentives for private sector activity. These actions are desirable in their own right and would also probably increase the ability of the monetary authorities to make a more effective contribution to economic policy.

## III. MONETARY POLICY AND THE RECENT BEHAVIOR OF THE ECONOMY

Economic growth has slowed over the past year after a period of rapid expansion in the first 18 months of recovery. The rate of advance of the economy during the early phase of the recovery was the fastest for any comparable period since the recovery of 1949-50 merged with the economic impact of the Korean War. Monetary policy played a strongly supportive role in the expansion. M1 growth began to accelerate after mid-1982, after two separate periods of monetary flatness in 1981 and 1982, and the economy began to expand by late 1982, approximately six months after the upturn in money. M1 grew at nearly a 14 percent annual rate from July 1982 to June 1983 and at about a 7-1/2 percent annual rate from June 1983 to June 1984.

One of the striking features of this early phase of the expansion was the rapid advance of interest-sensitive sectors:

- o business spending for capital equipment rose at a 21 percent annual rate from late 1982 to mid-1984
- o residential construction rebounded at a 30 percent annual rate during the same period.

The rapid pace of the recovery and the strength of interest-sensitive sectors came as a surprise to those who overemphasized the short-run effects of budget deficits and high real interest rates. Most standard econometric models consistently underestimated real growth and overestimated inflation during this period. One reason for the relative failure of these economic forecasts to predict the strength of the recovery was probably their underestimation of the directly stimulative effects of accommodative monetary growth, particularly since it followed a period of intense monetary restraint and may have been largely unanticipated. Another factor of equal, if not greater, importance was the 1981 tax incentives which had powerful effects on after-tax rates of return and contributed to the stronger than expected performance of investment during the expansion.

After growing at about a 7 percent annual rate during the first six quarters of the current expansion, the economy has slowed to about a 2 percent annual rate of growth over the most recent four quarters. Employment gains have continued, although confined to the service sector of the economy, and the civilian rate of unemployment has remained stable near 7.3 percent in the first half of this year. While the overall performance of the economy has remained satisfactory and inflationary pressures are still remarkably subdued, it is understandable that this slower pace of growth would arouse concerns as to the future path of the economy and raise questions about the appropriate role of monetary policy.

There is some difference of opinion as to the causes of the current slowdown. On monetary grounds it might be argued that the current slowdown has largely been induced by very slow growth in M1 in the second half of 1984 when M1 was virtually flat from June to October, and that these effects have not yet been reversed by the rapid expansion of M1 at more than a 10 percent annual rate since last October. The recent monetary pattern is shown in Chart 3.

While this monetary view of the slowdown in real economic growth is the most likely explanation, some questions remain. The sharp drop in the growth of monetary velocity to a negative level in the first quarter of this year was probably to be expected since velocity does typically decline temporarily when monetary growth accelerates. But the persistence of negative growth in velocity through the second quarter and the absence of clear signs of resurgent economic activity have been somewhat unexpected. It is also disturbing in this connection that on purely monetary grounds a very weak first quarter was predicted for the first quarter of 1984 (which turned out to be the strongest quarter of the current expansion) and a return to high rates of inflation was predicted for 1984 (which turned out to be a very good year in terms of inflation performance).

The inherent difficulty of attempting to move from known or assumed rates of monetary growth over brief periods of time to resulting rates of growth in real activity can be seen rather readily from Chart 4. It is reasonable inference that the prolonged, if somewhat irregular, acceleration of monetary growth after late 1981 helped pull the economy to higher levels of real growth by mid-1983. It is equally reasonable to infer that a prolonged deceleration of money growth from peak levels near a 15 percent annual rate in late 1982 to less than 5 percent by 1984 has been at least partly responsible for the eventual slowdown of the economy. But it is questionable whether much

more could safely be inferred or whether the timing and extent of the economy's reaction to the latest burst of monetary growth could be predicted with very much confidence on purely monetary growth grounds.

It is generally recognized that the short-run relationship between monetary growth and economic performance is uncertain at best. Over the longer haul, however, the experience since World War II suggests that there is a close association between the two. Specifically, and without exception, periods of significant acceleration of monetary growth have been followed by some increase in the pace of economic activity. For example, the long steady acceleration in M1 growth in the late 1960's that accommodated Keynesian-type fiscal policies and the Vietnam war effort was associated with an upswing in economic activity which peaked at the end of 1969 -- with undesirable consequences in terms of inflation. More recently, as noted previously, growth of the money supply picked up sharply in late 1982 and brought the economy out of the 1982-83 recession. In the same manner, periods of significant slowdowns in monetary growth have been followed by deceleration of economic growth, for example, the 1973-1974 slowdown in money growth was followed by a recession as, more recently, was the slowing of money growth over 1981-1982.

There has never been a speedup of monetary growth in the period since World War II of the duration and magnitude that has taken place since last October without some resulting pickup in economic activity. It is therefore reasonable to expect that a recovery in economic growth lies ahead. However, the recent instability of monetary velocity introduces some additional uncertainties and leaves the exact timing and extent of any monetary-induced pickup in the economy somewhat open to question.

In addition to purely monetary influences, the current phase of slower growth can be viewed as stemming partially from real factors. Inventory restocking was an important element in the economy's initial phase of rapid advance. There was a swing from decumulation in real terms at a $25 billion rate at the recession trough in late 1982 to accumulation at a $27 billion rate during the first half of 1984. By the first half of this year, inventory accumulation had fallen back to about a $12.5 billion annual rate. Much the same pattern of a cutback in the rate of inventory accumulation following an early recovery rebound has emerged at roughly similar stages of earlier expansions, e.g., in 1962 and 1976. As such, this could be construed as a normal cyclical response to the speed of gains early in the expansion. With inventory-sales ratios now pulled down to relatively low levels, the stage may be set for a renewal of cyclical expansion.

Another real factor that may also have a bearing on the current slowdown is the behavior of the net export component of GNP. There has been a fairly steady deterioration in net exports from a surplus in late 1982 of about $25 billion at an annual rate in real terms to a deficit at nearly a $35 billion annual rate in real terms by the second quarter of this year. Since mid-1984 when the current slowdown began, industrial production has been relatively flat and manufacturing employment has declined. It is possible that steadily intensifying competition from imports since that time has been responsible for the current slowdown, but the case is weakened by the fact that the gap between changes in Gross Domestic Purchases and Gross National Product in real terms was actually slightly wider earlier in the expansion than it has been recently. It seems likely that the net export effects were masked by the rapid early pace of the expansion and are now simply more visible as growth in domestic demand has slowed.

A more mature stage of expansion is normally characterized by a transition to slower growth. Some of the reasons have been cited here and there may well be still other influences from the real side of the economy. However, a good portion of the recent slowdown in the economy can probably be attributed to last year's slow growth in money. Because of the looser relation recently between money and nominal GNP it is not possible to be precise as to the monetary influence.

Despite this uncertainty as to the proper weight to be given to real and monetary factors in explaining the recent slowdown in growth, the near-term economic outlook appears to be generally favorable. The second quarter rise in real GNP was marked down to a 1.7 percent annual rate from 3.1 percent in the flash estimate. Paradoxically, however, the composition of the revised set of figures was more favorable than the higher flash estimate and seems to point to the likelihood of better economic performance in the second half of the year.

- The bulk of the markdown from the flash estimate came in business inventory investment which is now calculated as dropping in real terms from $19 billion in the first quarter to $6 billion in the second (both figures in 1972 dollars and at annual rates). As shown in Chart 5, inventory-sales ratios are currently at relatively low levels, particularly among manufacturing industries. Thus, the second half could witness a step-up in production for inventory, which would give a lift to the economy.

- After a small decline in the first quarter, real final sales (GNP less inventory investment) grew at a 5.1 percent annual rate, according to the latest estimates, just a shade less than had been estimated in the flash. Greatest strength was in spending for structures, as resident'al construction, business investment in structures, and state and local construction all rose sharply. Real final sales of durable goods also registered a good gain, boosted by a resumption of shipments of computers following a hiatus in the first quarter.

- Indeed, all major components of real GNP turned in strong showings in the second quarter, with the exceptiсn of inventory investment and the net export balance.

Private economic forecasts generally call for a faster pace of expansion in the second half of the year and a continuation of real growth in 1986. Results of some major economic forecasts are summarized below:

Growth in Real GNP
(percent change, annual rate)

| | 1985 | | | 1986 |
|---|---|---|---|---|
| | III | IV | IV to IV | IV to IV |
| Data Resources Inc. (7/85) | 2.7 | 2.0 | 2.1 | 2.5 |
| Chase Econometrics (6/25/85) | 2.9 | 3.2 | 2.3 | 2.3 |
| Wharton EFA (6/26/85) | 3.6 | 2.9 | 2.4 | 2.4 |
| Townsend-Greenspan (5/85) | 4.1 | 4.3 | 3.3 | 2.1 |
| Blue Chip Consensus (7/10/85) | 3.9 | 3.7 | 2.7 | 2.3 |

The Administration is currently reviewing its own economic projections which will be released with the Mid-Session Budget Review. The slower than expected first half will make some dent in the real growth performance for the year but for the reasons indicated previously stronger second-half performance seems very likely. Despite the generally favorable indications, stronger second half performance cannot simply be taken for granted. The duration of the current slowdown has been something of a surprise and economic forecasting is at best an uncertain art. This argues for prompt legislative action on the budget and tax reform coupled with reasonably accommodative monetary policy.

## IV. SOME AREAS OF MONETARY UNCERTAINTY

Monetary policy will have to be conducted cautiously during the remainder of the year. There are risks on both sides. Too rapid a pace of monetary expansion on the heels of the sharp monetary growth since last October could sow the seeds of future inflation. Too restrictive a stance could deepen the current slowdown, widen the budget deficit and aggravate the international debt situation.

Currently, the economy is advancing while inflation is still under good control. But there are some aspects of the monetary situation which, while perhaps not unique, do seem to depart significantly from recent experience. There appear to be three of these major areas of uncertainty which make a cautious approach to monetary policy almost obligatory. Each may be clarified by experience during the balance of the year but for the time being considerable uncertainty remains.

### A. The Puzzling Behavior of Monetary Velocity

Reference has already been made to the fact that the postwar trend in M1 velocity appears to have been interrupted in recent years. Velocity has behaved very unpredictably in the current expansion. In the first year of the expansion, velocity did not rise at all despite the fact that historically it has had a strong pro-cyclical pattern. That cyclical strength seemed to emerge -- a little behind schedule -- in the second year of the expansion when velocity rose at a 4 percent annual rate. But velocity has now declined at about a 5 percent annual rate during the first half of this year. This is simply another way of saying that the previous relationship has shifted in an unexpected fashion. There is still a link between money and nominal GNP but more M1 is needed to support a given level of economic activity.

In his July 17 statement, Chairman Volcker reviewed recent velocity experience and concluded that:

> "We simply do not have enough experience with the new institutional framework surrounding M1 (which will be further changed next year under existing law) to specify with any precision what new trend in velocity may be emerging or the precise nature of the relationship between fluctuations in interest rates and the money supply."

A major difficulty in this connection is separating the effects upon velocity which might be independently attributable to changes in interest rates from effects which may reflect much broader influences. As interest rates decline, the opportunity cost of holding larger cash balances also declines which may tend to reduce velocity as more money is held at any given level of GNP. But if the velocity decline is the driving force in the sequence, interest rates will decline because the economy is declining. While a decline in velocity might be regarded with relative equanimity in the first sequence it hardly would be in the second. The difficulty is knowing in advance whether interest rates are moving velocity, or whether velocity and the economy itself are moving interest rates.

Attention has been directed recently to the possibility that the observed decline in velocity may be due to the growing importance of interest-sensitive components contained in M1. Until 1980, M1 was a fairly pure measure of money held for transactions purposes. Subsequently, payment of interest on NOW and Super NOW accounts, which are included in M1, may have drawn into M1 a large amount of deposits which prior to 1980 would have been included in M2. The result may be that M1 has become more like M2 and for a given level of nominal GNP the measured level of velocity would be lowered. This conforms with the general pattern of below-trend levels of velocity in recent years and may be a partial explanation of some of the observed behavior of velocity.

It does not, however appear to offer an adequate explanation for the recent velocity slowdown which has been associated with slower economic activity this year. Some analysts have attributed the drop in velocity to the rapid growth of interest-bearing checkable accounts which have become more competitive with other interest bearing instruments. However, even if these checkables had grown no faster than noninterest bearing demand deposits, velocity still would have fallen during the first half of this year -- at about a 2 percent annual rate. Typically in the past velocity has increased by about 4 percent during the third year of an expansion.

With velocity behaving so unpredictably, the Federal Reserve cannot be sure what path of total spending and nominal GNP is likely to be associated with any given rate of growth in money. This certainly does not mean that the monetary (and credit) targets can safely be abandoned. Inflation is still a serious potential threat. But the success of a rigid monetarist approach depends ultimately on the predictability of velocity. This may not be too significant where the objective is limited to the long run control of inflation, but it assumes dominating importance where a particular short-run relationship is assumed to exist between money and nominal GNP.

The fact that recent experience is so difficult to interpret implies a need to continue to give attention to the growth rates of M1 and the other monetary aggregates, but also watch carefully other indicators of the economy's performance in order to determine whether the targets are consistent with maximum noninflationary real GNP growth.

B. Growing Importance of the International Dimension

The U.S. situation since 1980 has featured a massive net capital inflow without parallel in the postwar period. This has been the driving force in exchange markets. The reasons include low U.S. inflation, generally good to excellent U.S. economic performance, and the traditional role of the U.S. money and capital markets as a safe haven for foreign funds when there are economic difficulties abroad. Above all, the free-market orientation of the Reagan Administration and the higher prospective rate of return here on productive investment has acted as a powerful magnet attracting foreign capital.

Flows of the type, magnitude and duration we have experienced are not induced by fleeting interest rate differentials as if foreigners were shopping for a better money market fund. These massive flows have been induced by a generalized perception that the U.S. economy has found a new direction and offers significantly higher after-tax rates of return on productive investment. Some observers completely reverse these obvious lines of causation and argue that the U.S. budget deficit has driven up interest rates and pulled in foreign capital. Surely it must be obvious that this does not explain five years of dollar appreciation during which time budget deficit projections have risen and interest rates have fallen. Foreigners invest in the U.S. despite our budget deficits not because of them. It is true that our failure now to take effective action to reduce government spending coupled with overly rapid money growth could drive the dollar down, but obviously that is a sequence that we must avoid.

Capital inflows and the appreciating dollar are not the only influence on the U.S. balance of payments by any means. Differential rates of growth here and abroad, trade barriers, changing patterns of competitive ability, and U.S. export losses associated with the LDC debt situation have all exerted an important influence from time to time. The list could be lengthened. It is also important to recognize that there has been a changing

pattern within the capital accounts in the last 18 months or so. The more recent pattern has been a continuing net capital inflow to this country because of reduced U.S. outflows, partly because of reduced bank lending to Latin America.

The strength of the U.S. dollar is a testimonial to the essential correctness of the policies that the Reagan Administration has introduced. Greater emphasis on incentives to work, save and invest -- the supply side of the economy -- has been coupled with effective control of inflation -- to which the strong dollar has itself made its own important contribution. As a result, the U.S. economy has been strong, capital has flowed to this country and the dollar has been bid up in price. It is understandable that we do not want to see those successful policies reversed in an ill-advised effort to bring the dollar down.

There is considerable evidence which would suggest a fairly direct linkage between growth in the money supply and the dollar exchange rate. Because the dollar has appreciated steadily due to real factors, the monetary influence has not always been recognized but it surely exists. From October 1980 to July 1982, sharply slower money growth (4.8 percent annual rate) and lower inflation led to a rapid climb in the dollar (19.9 percent annual rate), as confidence in its purchasing power was restored and people worldwide began trying to rebuild their dollar holdings in the face of tight supply. Faster money growth from July 1982 to June 1984 (10.4 percent annual rate) accommodated the worldwide dollar build-up and slowed the dollar's advance (6.6 percent annual rate). A renewed slowdown in money growth from June 1984 to December 1984 (4.1 percent annual rate) led to a renewed surge in the dollar (23.5 percent annual rate). These successive episodes are shown in Chart 6.

Faster money growth since December 1984 finally caught up with the dollar in late February, and the dollar has fallen back from its peak levels. It is to be hoped that a more stable monetary policy and a steadier dollar will benefit hard-pressed sectors of the U.S. economy. Agriculture and mining have suffered from commodity price declines related to overly tight money and the strong dollar. Exporters and import-competing industries have also had difficulty coping with the rapid climb in the dollar's value.

The risk is that continued rapid monetary growth would begin seriously to undercut the dollar's value. This, in turn, could begin to add to inflationary pressures and to reverse the gains in that area that have been achieved in recent years. The best

course of action is for monetary policy to pursue a neutral, non-inflationary course and allow the dollar exchange rate to be determined on the basis of real factors such as comparative costs and anticipated real rates of return here and abroad.

## C. The Process of Disinflation

It is clear that a disinflationary process is still continuing here and abroad. In the three months ending in March of this year, the crude materials component of the U.S. producer (wholesale) price index fell at nearly a 20 percent annual rate and by about a 10 percent annual rate in the latest three month period ending in June. When commodity prices slump, or even when commodity futures prices decline sharply, it can be a signal that the Federal Reserve is moving too rapidly toward disinflation, and is risking recession.

Some economists feel that the disinflationary process is proceeding too fast. They argue that the Federal Reserve concentrates too closely on regulating the growth of the money supply. In their view, the dollar has been made very scarce both at home and in international markets. This can be inferred, they argue, from the appreciation of the dollar since 1980, the fall in the price of gold from nearly $900 to about $300 and the persistent weakness in basic commodity prices here and abroad. Some would even argue that the Federal Reserve should substitute a price rule for a quantity rule, i.e., seek to stabilize some index of prices rather than to regulate the growth of the monetary aggregates.

The weight of economic opinion favors a quantity of money approach and that is where emphasis has been placed. However, those who have directed attention to the disinflationary process have performed a useful service. Prices have not responded to monetary growth as would have been expected on the basis of past experience. In the last analysis, it is doubtful whether any permanently rigid rule for monetary policy is likely to deal adequately with the complexities of the economy.

With the disinflationary process still continuing, the risks of a return to accelerating inflation seem to be low but the costs of being wrong would be enormous. Not quite fifteen years ago, wage and price controls were imposed with inflation little higher than it is now -- except in the wholesale price area. Following that ill-advised experiment, U.S. inflation surged to

double-digit levels and some nominal interest rates reached record peaks. Those past errors must never be repeated. And, rapid monetary growth continued long enough has always generated inflation.

On the other hand, there are signs here and abroad that inflationary pressures are much reduced. Actual deflation has been occurring in some key areas although not, of course, in terms of general price levels. This suggests that the monetary authorities will need to follow the disinflationary process by monitoring a wide range of price and cost indicators. They will also need to follow the position of the dollar in the foreign exchange markets as well as the growth of velocity in determining whether or not a certain target range for money growth is appropriate. When there is clear evidence of change, the targets can be rebased but not so frequently as to permit a purely discretionary policy with the monetary targets serving as stage scenery. There will be a continuing need for rules in the execution of monetary policy but they must be applied and interpreted in the light of changing circumstances.

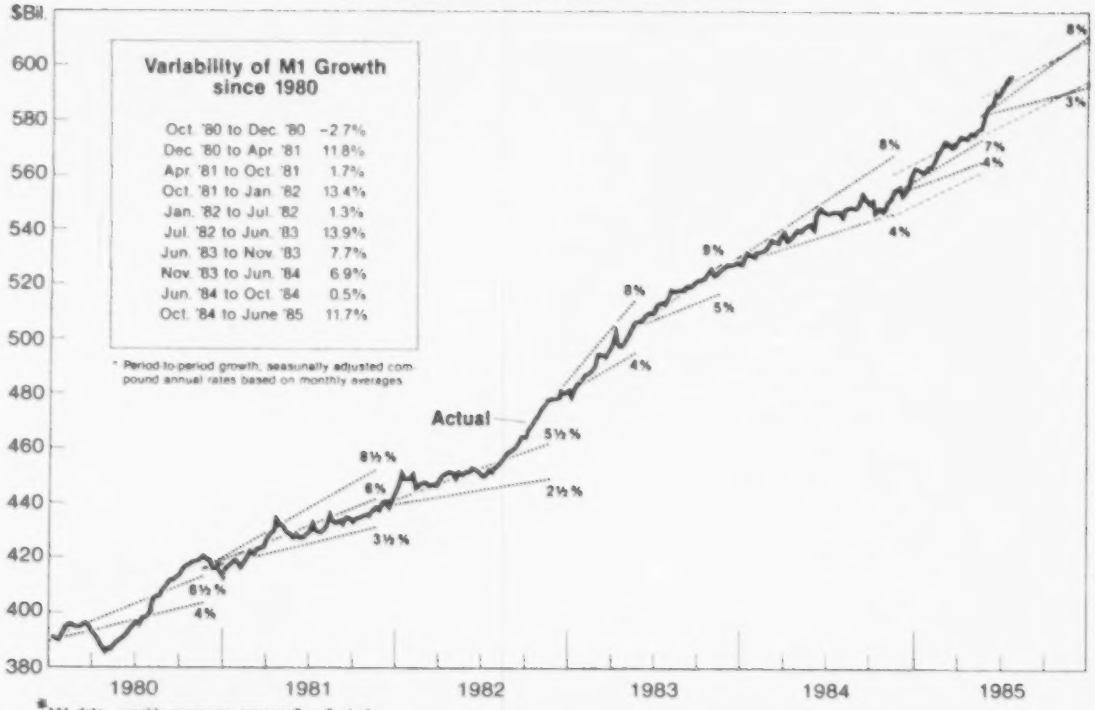
## V. CONCLUSION

It would probably be a mistake to draw sweeping conclusions from recent experience with the conduct of monetary policy. The Federal Reserve appears to have been doing a reasonable job this year in dealing with a rather complex situation. The Administration has been critical of some aspects of monetary policy in the past and reserves the right of criticism in the future. But the Federal Reserve is most likely correct now in deciding to rebase its money supply target for M1 and in proceeding with caution with respect to the new target. For example, it would be possible for M1 to grow at a flat or slightly negative rate for the remainder of 1985 and still be within its new target range. This kind of swing in M1 growth would be entirely unacceptable from the Administration's point of view. However, M1 growth consistent with its upper target band seems acceptable at this point.

The economy needs the support of an accommodative monetary policy and would benefit from lower interest rates. The monetary authorities must also remain closely alert to the needs of the international situation and -- above all -- prevent any significant acceleration of inflation. They will need to follow the course of the economy very closely in the period immediately ahead.

Chart 1

## $M_1$ VERSUS TARGET RANGE*




**Variability of M1 Growth since 1980**

| | |
|---|---|
| Oct. '80 to Dec. '80 | −2.7% |
| Dec. '80 to Apr. '81 | 11.8% |
| Apr. '81 to Oct. '81 | 1.7% |
| Oct. '81 to Jan. '82 | 13.4% |
| Jan. '82 to Jul. '82 | 1.3% |
| Jul. '82 to Jun. '83 | 13.9% |
| Jun. '83 to Nov. '83 | 7.7% |
| Nov. '83 to Jun. '84 | 6.9% |
| Jun. '84 to Oct. '84 | 0.5% |
| Oct. '84 to June '85 | 11.7% |

* Period-to-period growth, seasonally adjusted compound annual rates based on monthly averages

*M1 data: weekly averages, seasonally adjusted.
Fed target ranges: seasonally adjusted simple annual rates based on quarterly averages.
In 1981 both M1-B and M1-B "shift adjusted" ranges are shown: the M1-B range is 6—8½%; the M1-B "shift adjusted" range is 3½—6%. Monetary bands are also shown for 1985.

Chart 2

## ACTUAL $M_1$ VELOCITY VERSUS TREND VELOCITY

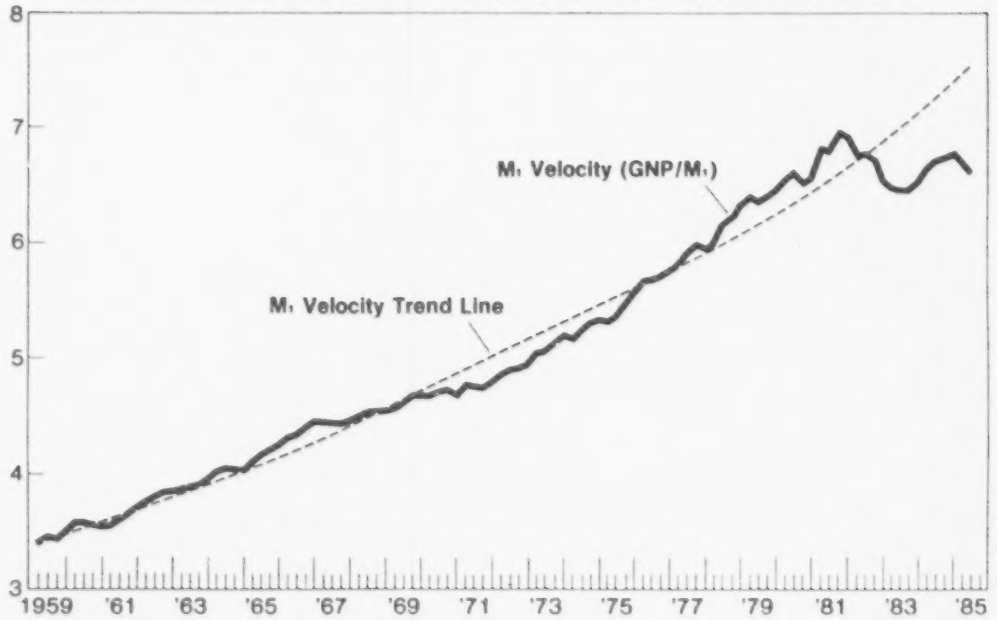
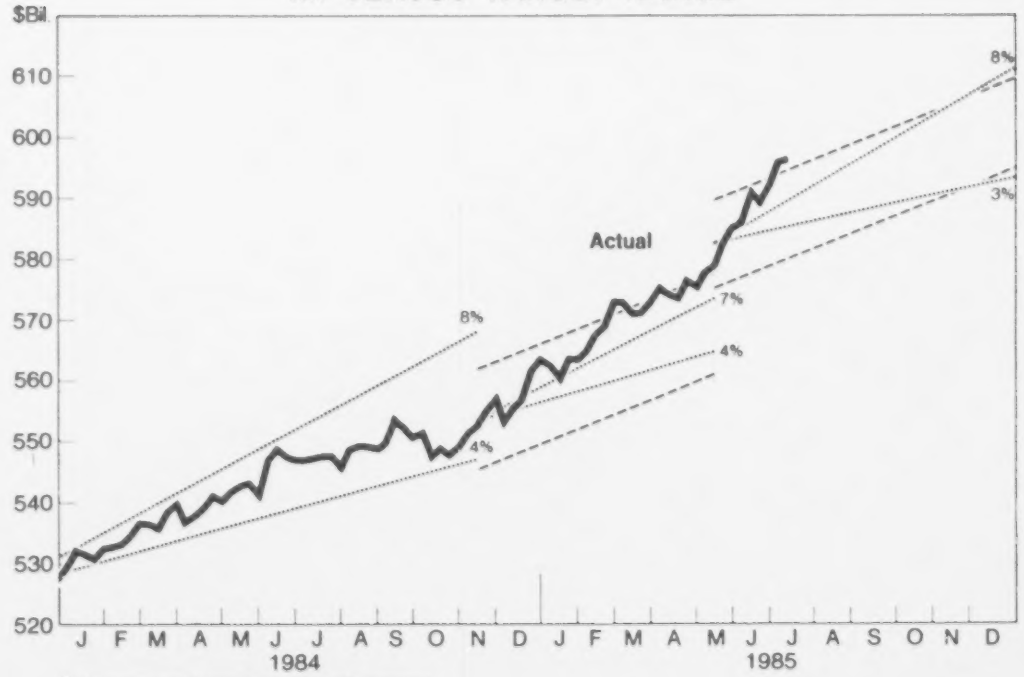


Chart 3

## $M_1$ VERSUS TARGET RANGE*




* M1 data: weekly averages, seasonally adjusted
Fed target ranges: seasonally adjusted simple annual rates based on quarterly averages

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Chart 4

## Growth of Real GNP and Money Supply (M1)

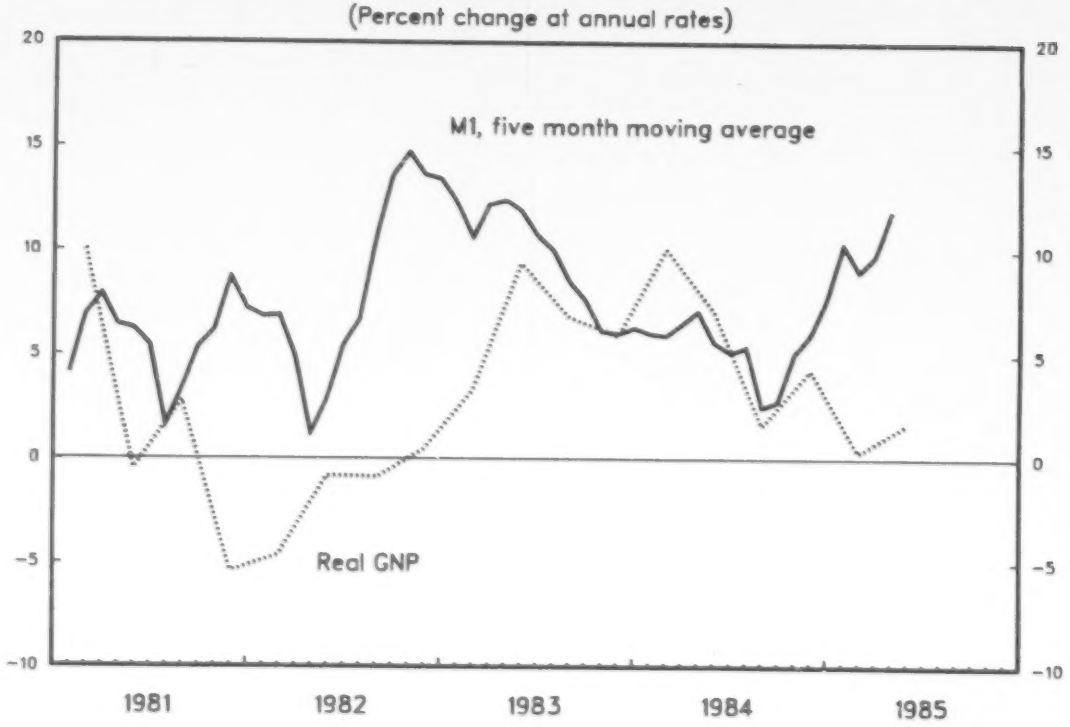
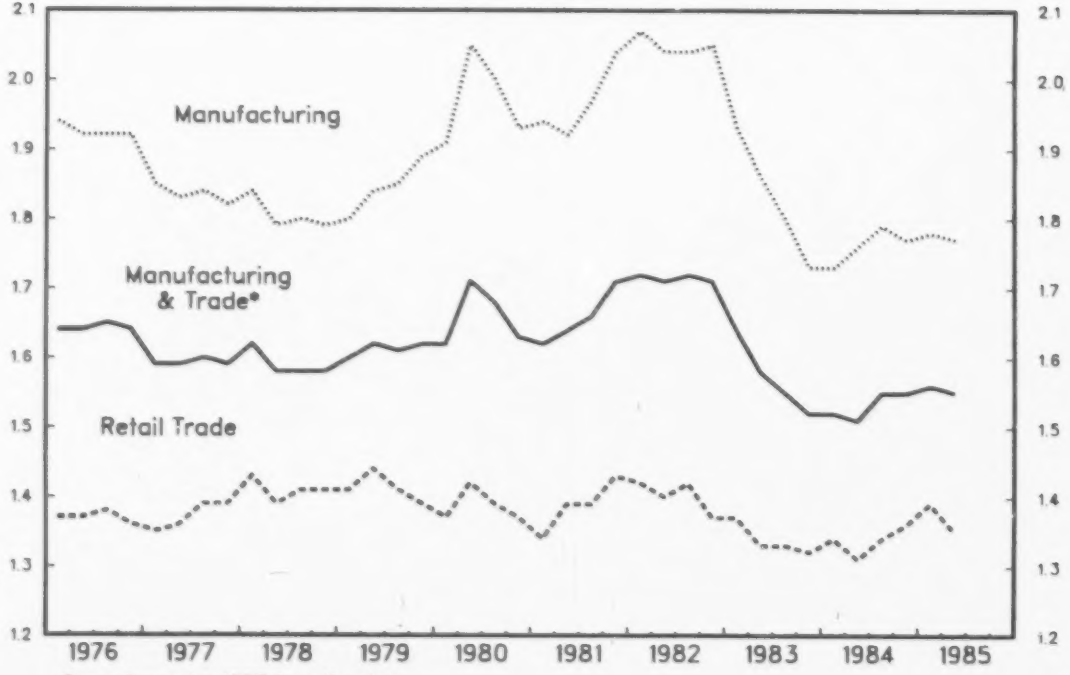


Chart 5

## Constant-Dollar Inventory-Sales Ratios

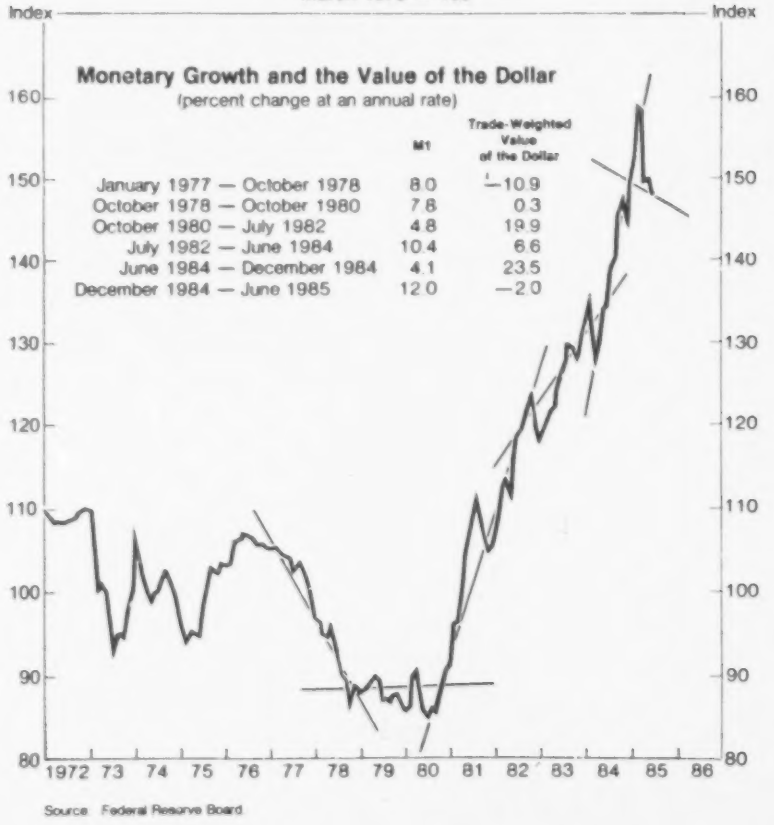



Second quarter 1985 is estimated.
*Includes wholesale trade not shown separately.

Chart 6

## TRADE-WEIGHTED VALUE OF THE DOLLAR

March 1973 = 100


Index
Index
Monetary Growth and the Value of the Dollar
(percent change at an annual rate)
M1
Trade-Weighted Value of the Dollar
January 1977 — October 1978 8.0 —10.9
October 1978 — October 1980 7.8 0.3
October 1980 — July 1982 4.8 19.9
July 1982 — June 1984 10.4 6.6
June 1984 — December 1984 4.1 23.5
December 1984 — June 1985 12.0 —2.0
160
150
140
130
120
110
100
90
80
1972 73 74 75 76 77 78 79 80 81 82 83 84 85 86

Source: Federal Reserve Board

August 12, 1985

STATEMENT TO THE UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Benjamin M. Friedman
Professor of Economics
Harvard University

Mr. Chairman:

I am grateful for this opportunity to offer my views to the Committee as it considers the mid-year report on monetary policy submitted last month by the Board of Governors of the Federal Reserve System.

As is already widely recognized, the major news contained in this report was the decision of the Federal Open Market Committee to maintain the recent more accommodative posture of monetary policy, rather than reverse course in response to the rapid growth of the narrowly defined M1 money stock during the first half of this year. By June M1 had risen from its average level in the fourth quarter of 1984 by 11.6%, measured at a seasonally adjusted annual rate — well beyond the 4-7% target range that the Federal Reserve had reported to the Congress in February. To have so constrained M1 growth in the latter half of this year as to achieve a total growth of 7% or less for 1985 as a whole would have required sharply slower growth of bank reserves and sharply higher short-term interest rates. Rather than shift policy in this way, the Open Market Committee chose formally to disregard the unexpectedly large M1 growth in the first half, and to adopt a 3-8% per annum target range for growth of this aggregate in the second half.

This decision was a correct one. The events of recent years have shattered confidence in rigidly fixed monetary growth rules as the central

focus of monetary policy. In the 1970s the acceleration of price inflation outpaced that of any familiar measure of money growth. In the 1980s neither the depth of the recession nor the subsequent deceleration of inflation corresponded at all closely to major sustained movements of money growth. Widely publicized predictions of either renewed recession or renewed inflation, based on temporary swings in money growth, have repeatedly proved embarrassingly wrong.

The unreliability of the relationship between macroeconomic activity and "money" is hardly surprising in light of the vast changes that have occurred in financial instruments and institutions in recent years. It is no longer possible in the United States to separate transactions balances from saving balances, or even to draw clear lines between deposits and other liquid claims. Money market deposits, sweep accounts, and money market mutual funds have irretrievably blurred such distinctions. Appeals to the tradition of the "quantity theory" today founder on having to say what is the quantity and what is the theory.

The Federal Reserve's decision to disregard the most recent growth of the M1 money stock makes sense in today's context for three reasons. First, even from the perspective of the M1 aggregate considered in isolation, the rapid growth in the first half of this year did little more than offset the sluggish growth in the latter half of 1984. From the second quarter of 1984 to the second quarter of 1985, M1 increased by 7.0%, easily within the 4-8% target range for 1984, and just at the top of the 1985 target range of 4-7%. If U.S. monetary policy operated on a June year instead of a December year, there would have been no aberrant M1 growth this year to consider in the first place. Moreover, the unevenness of M1 growth within the past year — 3.8% per annum in the latter half of 1984 versus 10.3% per annum in the first half of 1985 — is little cause for

concern either. There is no serious evidence indicating that money growth variations of this magnitude, sustained over periods as short as six months, affect the economy in any significant way.

Second, recent movements of the other monetary and credit aggregates now targeted by the Federal Open Market Committee do not confirm the impression of sharply excessive expansion given by M1. The much broader M2 aggregate, which includes M1 as well as such major components of the general public's liquid holdings as money market deposit accounts, savings and small time deposits, and money market fund shares, increased through June by 9.3% per annum, barely in excess of the 6-9% target range set in February. The still broader M3 aggregate, which includes M2 as well as mostly institutional holdings like time deposits in amounts of $100,000 or more, increased through June by 8.2% per annum, well within the corresponding 6-9 1/2% target range. Even the outstanding debt of domestic nonfinancial borrowers, which had expanded at a record pace in 1984, has increased this year (through June) by 12.7% per annum, only slightly in excess of the corresponding 9-12% monitoring range.

Finally — indeed, most importantly — available information bearing more directly on U.S. nonfinancial economic activity does not now suggest excessive strength that would call for a more restrictive monetary policy. After a rapid rebound from the unusually severe 1981-82 business recession, the U.S. gross national product has grown during the last year by only 1.9% after allowance for inflation. The economy's industrial sector has grown even more slowly during this period, and utilization of industrial capacity has been declining since last summer. Total employment has shown little recent growth, and the unemployment rate, which declined especially rapidly from its 11% recession peak, has now remained essentially unchanged at 7 1/4% for more than a year. Although the recent overvaluation of the U.S. dollar in

international exchange markets has led to unusually wide disparities in the performance of different sectors of the economy, overall there is little evidence to suggest that excessive expansion is any more likely a threat than insufficient strength over the horizon that matters for today's monetary policy decisions.

In this setting a major retreat from the kind of commitment to monetary targets that characterized the 1979-82 period was — and remains — certainly warranted. Even so, financial quantities like the money and credit aggregates still have some role to play in the monetary policy process for several reasons. The available evidence indicates that money and credit aggregates do contain some, albeit limited, useful information about subsequent swings in economic activity. Quantitative objectives for money and credit growth can also serve a useful function in the important process of Congressional oversight of monetary policy. It is also possible that public awareness of such objectives may be helpful in some further way, although on this subject there is little if any supporting evidence.

What role, then, should money and credit aggregates play in the design of monetary policy? The logical starting point for setting monetary policy should be the relationship between the macroeconomic objectives that policy seeks to achieve, in terms of prices, income and employment, and the actions that the Federal Reserve can actually implement — in practice, setting either nonborrowed bank reserves or short-term interest rates (or, equivalently, some measure of free reserves). Given the state of economic science, either relationship is subject to enormous uncertainty. Because banks and other depository institutions hold reserves not voluntarily but to back their outstanding deposits, the connection between reserve aggregates and economic activity suffers from all of the same problems as does that for

monetary aggregates. Interest rates are subject in this context to a different set of shortcomings, including the difficulty of knowing the "real" interest rate on any but very short-term debts when price inflation is uncertain, and of weighing the diverse effective interest rates on various borrowers and lenders subject to differential taxation.

Precisely because of these uncertainties, it is useful for monetary policymakers to do more than simply implement the rate of reserves growth or the short-term interest rate that they think is most likely to achieve their macroeconomic objectives. Specifying in addition the accompanying paths of money and credit growth that are most likely to be consistent with these objectives provides a benchmark for gauging, along the way, whether the chosen policy actions are having the desired effect. To the extent that the movements of these financial aggregates contain information about future economic activity, aberrant growth of money or credit flashes a signal warning that monetary policy may not be producing the desired effect, and that new action may be warranted. Because these signals are not fully reliable, however, any consequent action should hardly be automatic. Money and credit are appropriate "information variables" to be used along with other kinds of economic intelligence, not "targets" to be pursued willy-nilly as if they were of some value by themselves.

What the Federal Reserve should do is to treat the range that it specifies for each aggregate on which it focuses as what it now calls a "monitoring range." At the same time that it reports its macroeconomic policy objectives to the Congress, the Federal Reserve should specify ranges for money and credit growth that, as a matter of technical judgment, it considers most likely to be consistent with achieving those objectives. If growth of either money or credit then moves outside the specified range,

in its next semi-annual report the Federal Reserve either should state explicitly why it has changed the corresponding technical judgment or, alternatively, should reaffirm its original judgment and state explicitly how it is modifying its policy actions.

The latest action by the Federal Reserve appears, in substance, to be consistent with this "information variable" approach to monetary policymaking. The Federal Reserve did not simply disregard the recent rapid growth of the M1 money stock. Its mid-year report to the Congress explicitly considered the behavior of M1, as well as of M2, M3 and nonfinancial debt, and discussed possible explanations for the aberrant M1 growth. These technical judgments may be correct or incorrect, of course, and the policy decision taken may ultimately prove appropriate or counterproductive. On the basis of the evidence at hand, however, it was a right decision.

Conducting monetary policy in this matter clearly leaves important room for Federal Reserve discretion. Such a procedure neither follows a fixed rule for setting money and credit growth ranges, nor institutes automatic policy responses to movements of money or credit growth outside the set ranges. This choice of guided discretion over rigid rules may be unsatisfying to some, but today it is inevitable. The relevant relationships are too unreliable to warrant imposing any simple rule, and the plausible but unforeseeable shocks to these relationships — including further financial innovations, side effects of today's anchorless fiscal policy, international capital movements mirroring the nation's enormous trade imbalance, shifts in the public's portfolio preferences, changes in lending practices at major financial institutions, and so on — are too varied and complex to make feasible a more involved rule that attempts to lay down in advance a full complement of appropriate policy responses. Under today's circumstances discretion is inevitable, and in this case the Federal Reserve appears to have exercised it wisely.

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**A Gilbert Heebner**
Executive Vice President

CoreStates

August 5, 1985

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, DC 20510

Dear Senator Garn:

I am pleased to have the opportunity to share my views on the conduct of monetary policy in connection with the mid-year review of your Committee.

Monetary Policy Overview

In a fundamental sense the question at these review periods is always the same: has monetary policy been too accommodative, too restrictive, or about right? Even though economic activity was sluggish during the first half of this year, I would not argue that monetary policy has been too restrictive. Money growth was certainly not slow. Rates of growth in the aggregates placed M1 well above the target range for 1985, M2 near the top of the range, and M3 near the middle. Moreover, recognizing that the Federal Reserve more directly affects bank reserves than the money supply, total reserves grew at a rapid annual rate of 16.5 percent from December 1984 to June 1985. Chairman Volcker's description of the "approach in the provision of reserves" as "relatively 'accommodative'" (page 4 of his testimony) was by no means an overstatement.

While less conclusive as a gauge of monetary policy, it is also worth noting that interest rates and the foreign exchange value of the dollar declined significantly after the early months of the year.

If, as in my opinion, monetary policy has not been too tight in the period under review, has it been too easy? This question is raised principally by the rapid growth of M1. To be sure, such growth has not been accompanied by signs of higher inflation or of strong economic expansion. Accordingly, M1 velocity -- the ratio of nominal gross national product to M1 -- has fallen. An argument that monetary policy has been too easy must rest on the assumption that velocity will rise substantially in the period ahead and that the Federal Reserve will not at the same time be willing or able to slow the growth of M1.

I have little, if anything, to add to Chairman Volcker's extensive comments on the velocity question. The secular upward trend of M1 velocity may have shifted to a horizontal or even downward trend since interest is now paid on a substantial volume of checking accounts. The decline in velocity this year may have been associated with the fall in interest rates.

Given the uncertainties about velocity, I believe that the Federal Reserve was wise to rebase the M1 target to the second quarter of 1985 and to widen the target range for the balance of the year to an annual growth rate of 3 to 8 percent. To have continued with the original target range for 1985 and endeavored to come within it would potentially have been very restrictive, and might have sent the economy into a recession. On the other hand, to have downgraded the importance of M1 and eliminated a target range for that aggregate would have courted the risk of accelerating inflation. The option chosen by the Federal Reserve (rebasing and widening the range) seems to be a compromise intended to steer a course between the risks of recession and inflation. I believe that is how the option has been interpreted by the financial markets.

Nevertheless, we cannot rule out the possibility that the new range for M1 will prove to be too generous. If velocity were to return to the increasing rate that has in the past been more typical of the rising stage of the business cycle, money growth in the upper part of the 3-8 percent target range would be excessive (a judgment that seems consistent with the economic projections of the Federal Open Market Committee). This

combination of velocity and money growth would result in a rapid increase in nominal GNP.

The Federal Reserve is best advised to watch economic activity and money growth closely and be ready to apply the monetary brakes promptly upon evidence that money growth is stoking economic activity. We should not be lulled by the fact that at first rapid growth of nominal GNP would consist largely of increased real output. To wait until inflation accelerates before acting to slow the growth of bank reserves and money is to wait too long. We paid a high price to bring inflation down, and it would be unconscionable to allow it to rise again. Moreover, the current inflation rate of somewhat under 4 percent is not zero; it is not price stability.

I expect that economic activity will speed up in the months ahead, partly in lagged response to recent money growth and lower interest rates. Recent information on new orders, employment, the leading indicators, business inventories, and housing lend some support to this viewpoint. If indeed the pace of general business activity does accelerate significantly, manifesting a rise of velocity, I hope and presume that the Federal Reserve will not hesitate to slow the growth of the monetary aggregates.

Related Issues

I would like to mention a few other issues relevant to monetary policy. It would, in my opinion, be a mistake for the Federal Reserve to try to drive down the dollar by rapid money creation in the hopes of reducing the trade deficit. The dollar has already declined appreciably since early this year against major trading currencies. While a further decline would be helpful to spur exports and slow imports, deliberately trying to induce the decline at this stage by monetary policy would risk a plummet of the dollar.

Once foreigners perceived that the Federal Reserve was seeking to drive the dollar down by money creation, they would try to reduce their dollar holdings, accelerating the dollar's decline. This would, with a lag, raise the inflation rate in this country. Even sooner, interest rates would be pushed up as foreigners

sold dollar-denominated assets in face of rising inflationary expectations.

So much has been said about the Federal budget deficit that it is tempting to omit comment on it. But I do want to add my voice to the many others urging action to reduce the deficit. Economic logic suggests that our large deficit has contributed to higher interest rates than would otherwise prevail, although I recognize that the statistical evidence on this point is less than clear. A cut in the Federal budget deficit could help to bring about an orderly decline in the dollar. Furthermore, a good case can be made that in the longer run a large budget deficit crowds out capital investment and thus reduces productivity.

Finally, I want to draw attention, as did Mr. Volcker's testimony, to the rapid expansion of domestic nonfinancial sector debt. It is notable that this pattern is not peculiar to the past year. Debt has been growing significantly faster than gross national product in recent years, as shown in the accompanying chart of the ratio of debt to nominal gross national product. From the late 1960s to the late 1970s there was an upward drift in the debt-to-GNP ratio, but since then it has risen sharply. Total nonfinancial debt rose from 1.42 times GNP in 1978 to 1.55 in 1984. Importantly, this rise was not only a result of the increase of federal debt. The ratio of total nonfederal debt to GNP also rose sharply.

We need more information on the factors responsible for the rapid, and potentially dangerous, expansion of debt in the U.S. economy. Over the past year the substitution of debt for equity in connection with corporate mergers, leveraged buy-outs, and other types of financial restructuring has been a contributing factor. In the late 1970s and early 1980s, high current and expected rates of inflation may have encouraged borrowers to go heavily into debt with the expectation of repaying in cheaper dollars.

Whatever the reasons for the high debt position of the U.S. economy, there are important economic and policy implications. The current environment of reduced inflation and high real rates of interest is tough on debtors. Failures and debt problems are likely to continue to

surface among business firms and individuals. I feel strongly, however, that it would be a serious mistake for the Federal Reserve to respond to these problems by an easy monetary policy aimed at increasing the liquidity of the financial system. We should not try to "reflate" our way out of debt problems. If Congress decides that there is an overwhelming case for granting relief to a particular sector, it should do so individually, not by urging a change in monetary policy.

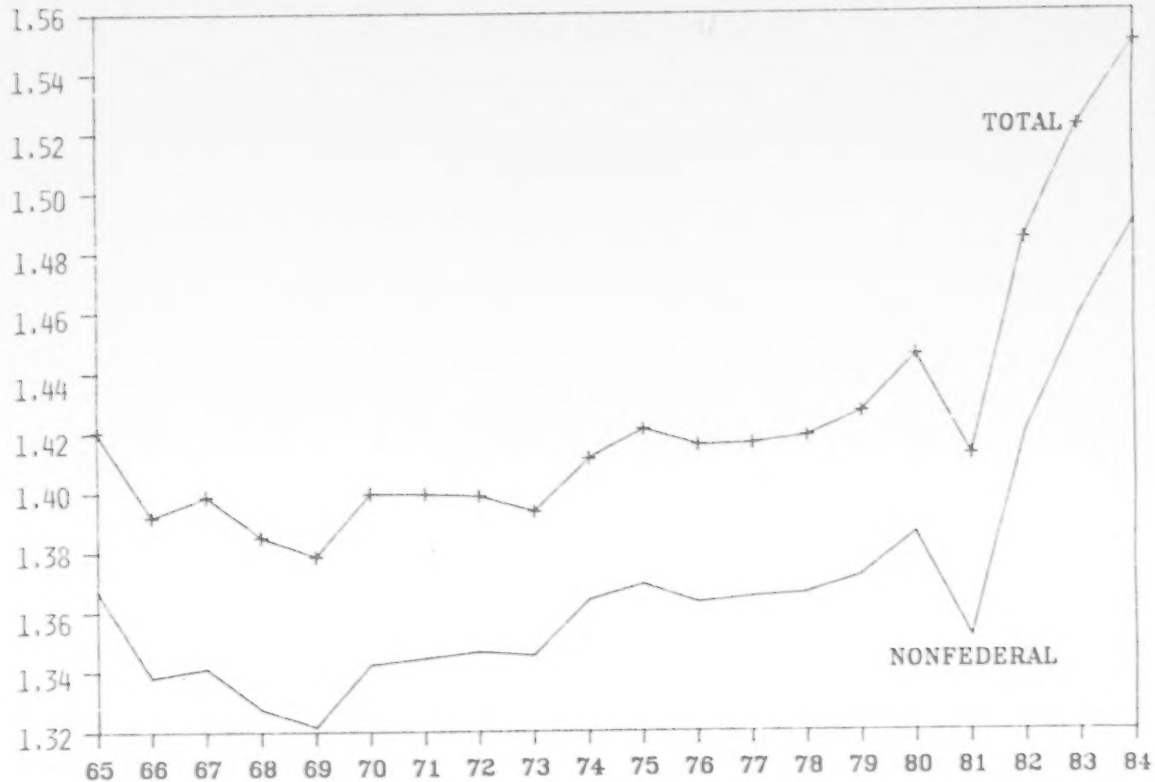
In closing, I feel that the semi-annual reviews of monetary policy conducted by your Committee and the corresponding one in the House of Representatives serve a most useful purpose. I appreciate this opportunity to submit my thoughts as part of your recent review.

Sincerely yours,

A. Gilbert Heebner

AGH:mr

DOMESTIC NONFINANCIAL SECTOR DEBT TO NOMINAL GROSS NATIONAL PRODUCT




Source: Board of Governors of the Federal Reserve System and Department of Commerce